

SUBCOMMITTEE ON OVERSIGHT
OF THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

REPORT AND RECOMMENDATIONS
ON
LOBBYING AND POLITICAL ACTIVITIES BY
TAX-EXEMPT ORGANIZATIONS



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LETTER OF TRANSMITTAL

SUBCOMMITTEE ON OVERSIGHT,
COMMITTEE ON WAYS AND MEANS,
Washington, DC, June 8, 1987.

Hon. DAN ROSTENKOWSKI,
*Chairman, Committee on Ways and Means, Longworth House Office
Building, Washington, DC.*

DEAR MR. CHAIRMAN: I am submitting to the Committee on Ways and Means the report and recommendations of the Subcommittee on Oversight concerning the Federal tax rules which govern the lobbying and political activities of tax-exempt organizations. The Subcommittee held 2 days of comprehensive public hearings to examine these issues on March 12 and 13, 1987.

The report includes a legislative history of the lobbying and political activity provisions of the Internal Revenue Code, a summary of present law applicable to lobbying and political activities, findings of the hearings, and the Subcommittee's recommendations unanimously agreed to on a bipartisan basis.

The Subcommittee respectfully submits this report and accompanying recommendations for your consideration.

Sincerely,

J.J. PICKLE,
Chairman.

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(VII)

I. INTRODUCTION

A. OVERVIEW

Section 501(c)(3) of the Internal Revenue Code allows a tax exemption for charitable organizations only where "no substantial part of the activities * * * is carrying on propaganda, or otherwise attempting to influence legislation (except as otherwise provided in subsection (h)),¹ and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office." Identical restrictions on legislative and political activity are contained in the provisions of the Code permitting charitable deductions from income,² estate,³ and gift taxes.⁴ Private foundations are subject to special excise taxes on prohibited expenditures for lobbying or political activity, though they may spend money in nonpartisan, widespread voter registration efforts.⁵ The most stringent Tax Code limits on lobbying and political activity are those imposed upon section 501(c)(3) public charities and private foundations. Other tax-exempt organizations are subject to less stringent, or in certain cases, no real limits. Thus, for example, a tax-exempt section 501(c)(4) social welfare organization may engage in lobbying activities⁶ and a section 527 tax-exempt political organization is expected to engage in political activities.⁷

Just as the Tax Code provides different limits on permissible lobbying and political activities by various types of exempt organizations, so is different income tax treatment accorded contributions and dues payments to such organizations. Contributions to 501(c)(3) public charities and private foundations are generally tax deducti-

Note.--Unless otherwise indicated in this document, all references to sections are to the Internal Revenue Code of 1986.

¹ Section 501(h) provides an elective standard for determining what is a substantial portion of the activities of a section 501(c)(3) public charitable organization. The limit is defined in terms of the amount of expenditures to influence legislation. Private foundations cannot make the election.

² Internal Revenue Code section 170(c)(2)(D).

³ Internal Revenue Code sections 2055(a)(2) and 2106(a)(2)(A)(ii).

⁴ Internal Revenue Code section 2522(a)(2).

⁵ Internal Revenue Code section 4945 public charities are also subject to tax on excessive lobbying expenditures under Internal Revenue Code section 4911 after a section 511(h) election.

⁶ Such an organization may be created and operated for the purpose of informing the public on controversial issues and may advocate particular views and changes in law. See, e.g., Rev. Rul. 68-656, 1968-2 C.B. 216. The ability of the (c)(4) social welfare organization to lobby without adverse tax consequences was explored at some length in *Regan v. Taxation With Representation*, 461 U.S. 540 (1983). Similar treatment is accorded section 501(c)(5) labor unions, section 501(c)(6) business associations, and section 501(c)(19) veterans organizations.

⁷ For more detailed background information on section 527 exempt political organizations, see CRS report, "Tax Treatment of Political Organizations and of Tax Exempt Organizations Engaged in Political Activities," Thomas M. Durbin (May 26, 1982) and CRS report 81-192A, "Federal Tax Law of Special Interest to Participants in Political Campaigns," Robert B. Burdette (revised August 5, 1981). Section 527 of the Internal Revenue Code was enacted in 1975 (P.L. 93-625, 88 Stat. 2116). It was intended to clarify the tax treatment of political organizations, including political action committees (PAC's). Such organizations are not taxed on their exempt function income and gifts to such organizations are not subject to a gift tax.

ble as charitable contributions under Internal Revenue Code section 170. Contributions to a 501(c)(4) social welfare organization, a 501(c)(5) labor union, or a 501(c)(6) business league are not, nor are contributions to political organizations.⁸

B. OUTLINE OF PRESENT LAW

Under present law, 25 different categories of organizations generally are exempt from Federal income tax.

Present law generally provides that a charitable organization for which deductions are allowed for Federal income tax purposes⁹ cannot engage in any political activity and cannot engage in more than an insubstantial amount of lobbying activity. Present law also provides rules under which certain organizations described in section 501(c)(3), other than private foundations, can elect to have the determination of the amounts that can be expended for lobbying purposes made under an objective formula (sec. 501(h)). Further, present law provides special rules restricting lobbying and political activity by private foundations.

In the case of exempt organizations for which charitable deductions for contributions are not allowed for Federal income tax purposes, the rules are much less restrictive. In some cases, both lobbying and political activities are allowed so long as those activities are not the principal activity of the organization.

Present law generally disallows business deductions for amounts spent for political activity and limits deductions for lobbying to expenditures for communications directly with a legislature regarding legislation that directly affects the taxpayer (sec. 162(e)). Thus, these rules generally are consistent with the rules which allow charitable deductions for amounts contributed to exempt organizations that cannot engage in any political activities and which restrict the amount of lobbying in which such tax-exempt organizations can engage.

Present law provides special rules for organizations (including political committees and political action committees) which are formed and operated primarily for political purposes (sec. 527). In general, these rules provide that these organizations are exempt from tax on income from contributions, member dues, fundraisers, etc., but are subject to tax on their investment income.

⁸ Dues to a business association or union may be deductible as an ordinary and necessary business expense under Internal Revenue Code section 162. Contributions or dues to political organizations are not.

⁹ Charitable deductions for contributions to exempt organizations generally are allowed for Federal income tax purposes only for contributions to organizations organized and operated exclusively for charitable, educational, religious, etc. purposes (sec. 501(c)(3)), contributions to fraternal organizations (sec. 501(c)(10)) where such contributions are used exclusively for religious, charitable, scientific, etc. purposes, and contributions to veterans' organizations (sec. 501(c)(19)).

II. PURPOSE OF SUBCOMMITTEE HEARINGS

The Honorable J.J. Pickle (D., Texas), Chairman of the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, held hearings on March 12 and 13, 1987, to review the Federal tax rules applicable to the lobbying and political activities of organizations that have tax-exempt status under section 501 of the Internal Revenue Code. These organizations include, among others: charitable, educational, etc., organizations; social welfare organizations; labor organizations; business leagues; and war veterans organizations.

The purpose of the subcommittee hearings was to investigate current law applicable to lobbying and political activities of tax-exempt organizations, and to determine the extent to which tax-exempt organizations undertake lobbying and engage in political activities. The subcommittee also investigated whether there has been any recent growth of activity in this area, considered the appropriateness of current law and policy in this regard, and reviewed the adequacy of Internal Revenue Service (IRS) enforcement activities. The scope of the hearings included a review of the overall, basic definitions of lobbying and political activities, but did not include specific review of the proposed regulations, published by the Department of the Treasury in the November 5, 1986, Federal Register, regarding lobbying by organizations electing under section 501(h).

In announcing the hearings, Chairman Pickle stated: "The Committee on Ways and Means has not conducted a full and comprehensive review of the tax rules applicable to the lobbying and political activities of tax-exempt organizations, even though some of these rules date back to 1934. Recent events have raised questions about the extent to which tax-exempt organizations are engaged in lobbying and political activities. In light of these developments and the concerns they raise, it is time for the subcommittee to take a hard look at exactly what tax-exempt organizations are doing, and to determine what current law allows. We will also be reviewing the extent to which IRS is enforcing these laws. Taxpayers have a right to be assured that organizations enjoying favorable tax treatment are operating for the public benefit."

III. SUMMARY OF HEARING TESTIMONY

THURSDAY, MARCH 12, 1987

Bruce Hopkins, Baker and Hostetler:

Mr. Hopkins is the author of "The Law of Tax-Exempt Organizations" (5th Ed. 1987) and teaches a course in the law of tax-exempt organizations at George Washington University's National Law Center.

In his testimony, Mr. Hopkins discussed the origin of Federal (and State) law for nonprofit organizations in the English common law of charity. He defined some of the charitable organizations that were the subject of the hearings, Internal Revenue Code sections 501(c)(3), 501(c)(4), 501(c)(6), 501(c)(19), and 527. Mr. Hopkins noted that the prohibitions for lobbying and/or political activity are the only features of section 501(c)(3) not evolving from common law, and that legislative history is sparse because these provisions were adopted in floor amendments with little debate as a result of the bias of some Members, rather than broad policy formulation.

Mr. Hopkins noted that if Congress determines lobbying and/or political activities are inappropriate for tax-exempt organizations, then a written rationale for that determination must be provided to the nonprofit community. In his opinion, a section 501(c)(3) organization ought to be able to lobby directly on matters of direct importance to its tax-exempt status.

In conclusion, Mr. Hopkins listed tax-exempt organization policy questions that the subcommittee should consider: whether lobbying and/or political activities are appropriate to advance a charitable purpose; whether present law is suitable; whether lobbying rules should be more like section 162(e) than current law; whether application of private foundation rules is appropriate; whether lobbying should be the principal factor of an organization; and, whether rules addressing the use of "in-tandem" organizations must be developed.

Jennie S. Stathis, Associate Director, U.S. General Accounting Office:

GAO testimony indicated that although IRS data on the nature and extent of lobbying and/or political activities are limited, the organizations most likely to engage in these activities are section 501(c) public charities, social welfare organizations, labor unions, business leagues, war veteran groups, and section 527 political organizations.

Ms. Stathis noted the lobbying and/or political activities are monitored by the IRS's Office of the Assistant Commissioner as part of administration of the over 800,000 tax-exempt organizations. IRS does not have a separate compliance program for these

activities. Data from fiscal year 1986 indicated the IRS examined 20,084 tax-exempt returns (5 percent) and lobbying and/or political activities was the principal issue in 432 (2 percent) of those examined. As a result of the examinations, tax-exempt status was revoked for 25 organizations, and the tax liability increased for 11 organizations.

Finally, Ms. Stathis indicated the Form 990 provided limited information on the lobbying and/or political activities. All political activity expenditures must be reported by all organizations required to file a Form 990; however, the form only requires section 501(c)(3), (5), and (6) organizations to report lobbying expenditures and only section 501(c)(3) organizations must identify the nature of these activities.

J. Roger Mentz, Assistant Secretary for Tax Policy, U.S. Department of the Treasury:

The Treasury Department testimony presented the policy considerations of current restrictions on lobbying and/or political activities and the conclusion that, although certain issues necessitate congressional attention, the basic statutory scheme should be maintained. Assistant Secretary Mentz noted that current policy regarding lobbying reflects compromise among competing views, and pointed out that any liberalization of rules relating to permitted lobbying by section 501(c)(3) organizations will have a substantial revenue impact. With regard to political activities, Treasury expressed support for continuation of the current prohibition in that Government should not subsidize campaigns and most campaigns are neither charitable nor educational.

Treasury provided suggestions on how Congress could address the following problems: affiliated exempt organizations, inappropriate sanctions, and successor organizations.

First, Treasury noted affiliated organizations can lawfully share facilities, staff, and equipment, yet it is almost impossible for the IRS to properly allocate expenses when separate returns are filed. Treasury *recommended* that the usefulness of the Form 990 to identify affiliated organizations could be improved if there was a statutory definition of an affiliated organization (recommended section 4911 as a guide), mandatory disclosure of all such affiliated organizations with taxpayer identification numbers, and penalties for failure to disclose. Also, Treasury expressed concern about complementary organizations where there are indirect benefits because of a common objective, but did not recommend solutions to address this.

Second, Treasury noted the need for sanctions which better reflect the severity of the violation and *recommended* the imposition of an excise tax when addressing lobbying activities. Treasury noted the significant improvement of the elective expenditure test over the substantial part test providing a more precise standard for application of the excise tax. Revocation would be reserved for those organizations exceeding the expenditure limits by a significant amount over a number of years. When addressing political activities, Treasury *recommended* imposition of an excise tax (similar to section 4945) on both the organization and the management who acted knowingly, and correction of the expenditure. Repeated and/or flagrant violations or failure to correct the expenditure would

result in revocation. Furthermore, Treasury believes that the revocation of an organization's tax-exempt status is an ineffective sanction for certain organizations and *recommended* additional sanctions could include a monetary penalty on the organization or a fine on the managers.

Third, Treasury noted organizations are violating current law, becoming shell organizations, and then forming successive organizations to continue the organization's operations. Treasury *recommended* the ability of the IRS to trace the series of successor organizations would be improved if Form 1023 required disclosure of current or previously existing affiliated organizations and a penalty was imposed for nondisclosure.

Assistant Secretary Mentz testified that section 504, which prevents a section 501(c)(3) organization from becoming a section 501(c)(4) organization if it has lost its exempt status due to excessive lobbying, was an important step for Congress and more steps in that direction may be appropriate. The Department's written testimony is set forth in its entirety in the appendix.

Lawrence B. Gibbs, Jr., Commissioner, Internal Revenue Service:

IRS testimony focused on its administration of current laws applicable to lobbying and/or political activities by charitable and other tax-exempt organizations.

Commissioner Gibbs noted that several statutory terms are inherently difficult to apply in specific facts and circumstances, such as the definition of lobbying. Furthermore, once the Service has determined that the activity falls within the scope of the restrictions, there are additional problems. First, attribution problems exist when determining which affiliated organization(s) acted together and also whether the action was taken by the organization or its managers. Second, quantification problems are presented when measuring substantial lobbying activities and allocating costs. Commissioner Gibbs noted that the quantitative analysis based on expenditures in section 501(h) provides significant advantage over the substantial part test. Commissioner Gibbs indicated that, even when activities are quantified, the examination agent must then decide whether the facts and circumstances of a case, which is the evaluation method the courts have used rather than set percentages, are sufficient to meet the substantial part test.

Along with the aforementioned attribution problem, Commissioner Gibbs indicated that there is an enforcement problem resulting from use of affiliated subsequent organizations. When the Service concludes that the lobbying restrictions have been violated, an organization will go out of existence and create a new organization. Typically, there is little consequence to the organization.

Commissioner Gibbs discussed the inadequacy of sanctions against those organizations which violated the prohibition on substantial lobbying and/or political activities. With regard to political activities, the loss of exempt status is unreasonably severe where the activity is not extensive, and, as a result, agents are reluctant to impose the sanctions. However, the sanctions may be unreasonably light if the organization has little or no taxable income. Commissioner Gibbs analogized the situation to that which existed for private foundations prior to the enactment of section 4945 in 1969.

With regard to lobbying activities, loss of exemption or a sanction becomes even more difficult for the Service because of the problems inherent in measuring these activities. Commissioner Gibbs pointed out that the lack of precise standards causes the IRS a problem when attempting to enforce the law uniformly and also has a negative effect on the charities which can not gauge the permissible level of lobbying activities.

Lastly, Commissioner Gibbs provided an outline of the current Exempt Organization Enforcement Program. The Service selects returns for examination from the following four independent sources: a computer scoring system (selects most of the examined returns); the Taxpayer Compliance Measurement Program for exempt organization returns (last done between 1980 and 1985); public information (conducted by district office to minimize political influence); and a special emphasis program. Commissioner Gibbs stated that current IRS staff is adequate to monitor the activities. Commissioner Gibbs suggested a special emphasis program may be appropriate to determine the extent of questionable lobbying and/or political activity and the establishment of the program is presently being considered at the IRS.

Commissioner Gibbs concluded that under current law the potential for tax abuse exists, and there is little risk of penalty on the organization, its managers or its contributors. The substance of the 1976 changes for lobbying are sound, but the IRS is left with two sets of rules and therefore it is difficult to enforce the law uniformly. Commissioner Gibbs reiterated his *recommendation* of the approach taken in 1969 affecting private foundations. The IRS's written testimony is set forth in its entirety in the appendix.

Scott E. Thomas, Chairman, Federal Election Commission:

FEC testimony focused on the FEC's role in regulating and examining the political activities of tax-exempt organizations.

If facts are brought before the FEC, according to Chairman Thomas, they are analyzed without regard to the tax-status of a group. Chairman Thomas discussed the regulation of "political committees" (authorized committees of candidates, political party committees, and PAC's) which may include regulation of tax-exempt organizations. These committees are subject to contribution and expenditure limits, reporting requirements and may not accept contributions from certain sources (i.e., corporations, unions, government contractors). Chairman Thomas indicated that for the most part there is no confusion as to the existence of a "political committee" under Federal election law. However, there may be groups that profess to be tax-exempt under section 501(c) and not "political committees," but close analysis indicates they are spending for the purpose of influencing legislation. Chairman Thomas also discussed the regulation of corporations and unions, which may be tax-exempt, to ensure compliance with statutory limits on their expenditures in connection with a Federal election.

Chairman Thomas indicated that there may be tension between Federal election laws and the tax laws in certain areas. Under current election laws, corporations and unions can pay the overhead of a separate political fund and can make partisan communications to a restricted group, while certain tax laws may restrict these activi-

ties. Yet, on balance, according to Chairman Thomas, there is a large degree of symmetry between the Code and the Federal Election Campaign Act.

Lastly, Chairman Thomas pointed out that the FEC does share information with the IRS in areas of overlapping concern, and they have recently met to discuss more efficient ways to share information in the specific area of tax-exempt organizations.

John B. Jones, Jr., Chair, Section of Taxation, American Bar Association:

Mr. Jones' testimony presented the A.B.A. Section of Taxations' view on the historical development of the current law governing legislative (lobbying) activities of public charities.

William J. Lehrfeld, Lehrfeld and Henzke, P.C.:

Mr. Lehrfeld expressed his belief that historically Congress and the Internal Revenue Service have attempted to use section 501(c)(3) lobbying limitations to serve petty political purposes, inhibit public debate, and punish the free exercise of constitutional rights. He noted the American public has been ill-served by the limitation on lobbying and no tax policy can support continued limitations. Mr. Lehrfeld *recommended* repeal of Code provisions that restrict lobbying and/or political activities of section 501(c)(3) organizations, including section 501(h) and section 4911.

Leonard L. Silverstein, Silverstein and Mullens:

Mr. Silverstein's testimony noted three areas which should be addressed and recommended corresponding solutions.

First, according to Mr. Silverstein, there is unequal tax treatment of lobbying and/or political activity depending upon whether it is conducted by a section 501(c)(3) charitable organization or one of the other section 501(c) organizations. Mr. Silverstein questioned the validity of the statutory distinction between private foundations and public charities simply based on the presence or absence of public support. He noted the distinction becomes more difficult to justify when public policy organizations are generating public support through sophisticated techniques (direct mail and media) and there is no existing linkage between the governing body and the diverse membership.

Mr. Silverstein *recommended* extension of the private foundation rules and regulations regarding lobbying and/or political activities to all section 501(c)(3) charitable organizations to make the playing field level. He indicated private foundations have adjusted to the current constraints and the constraints have been effective in eliminating abusive behavior. As an aside, Mr. Silverstein indicated that the proposed section 501(h) regulations should have eliminated grassroots lobbying for any section 501(c) organization that benefits from tax-deductible contributions.

Second, according to Mr. Silverstein, the problematic issues faced today would not have arisen if the Internal Revenue Service had been given effective statutory and administrative tools. Mr. Silverstein *recommended* an excise tax on an entity and its governing body, comparable to that in section 4945, for activities which improperly extend beyond the organizations purpose. He *recommend-*

ed that an appeals procedure be established within the IRS to respond to objections to the imposition of penalties. Mr. Silverstein indicated this would allay concerns of overreaction. He *recommended* the Justice Department, at the insistence of the Service and the Treasury, be empowered to seek violations of statutory and administrative provisions. Furthermore, Mr. Silverstein *recommended* increasing the Treasury and IRS staff that monitor compliance by tax-exempt entities and requiring organizations to submit more information on their governance and operation to assist this staff.

Third, according to Mr. Silverstein, consideration must be given the fact that private foundations alone are subject to a levy to compensate the government for monitoring the tax-exempt process. He *recommended* a 1-percent audit fee on all tax-exempt organizations with an exception for small organizations and certain institutions.

Brian O'Connell, President, Independent Sector:

Mr. O'Connell has served as president of Independent Sector since its inception in 1980. Independent Sector is an organization of 650 national organizations, foundations, business organizations and voluntary organizations working to promote and improve charitable activities.

Mr. O'Connell's testimony noted that one of the greatest threats to the advocacy rights of nonprofit organizations occurs when an exempt organization engages in illegal partisan political activity. He *recommended* that organizations transgressing the law should be dealt with directly and harshly through enforcement of the law; clarification of what is partisan under current law should occur without limiting lobbying rights; and any changes taken do not limit the right of organizations to express their legitimate influence. Mr. O'Connell indicated that electioneering, including the use of tax-exempt organizations by politicians that blatantly serve their candidates, undermines the integrity of nonprofit organizations.

He does believe current law is clear enough to distinguish legitimate advocacy from partisan activity.

Thomas A. Troyer, Caplin and Drysdale:

Mr. Troyer is the former chairman of the Exempt Organizations Committee of the A.B.A. Section on Taxation. He testified on behalf of Independent Sector.

Mr. Troyer testified on the importance of the 1976 law in encouraging public charities to present their information and advocate their views. He noted the law has liberalized prior tax restrictions on lobbying and clarified the ambiguity of the "substantial" part test. Mr. Troyer listed various organizations that have made the 1976 election and gave examples of the various activities of these organizations which are allowable contributions to public policy within the limits of the statute.

Harold P. Freeman, M.D., Chairman, National Advisory Committee on Cancer in the Socio-Economically Disadvantaged, the American Cancer Society:

Dr. Freeman is director of surgery, Harlem Hospital Center, and associate professor of clinical surgery, Columbia University. Dr.

Freeman's testimony was on behalf of the American Cancer Society (ACS).

According to Dr. Freeman, ACS is a section 501(c)(3) organization, with 2.5 million volunteers, which collected \$270 million in contributions in 1986. In 1987, ACS will spend over \$89 million on public and professional education efforts, and nearly \$42 million on direct service to cancer patients. Dr. Freeman indicated that many of the recent gains against cancer have resulted from congressional funding of the National Cancer Institute. ACS has lobbied each year to increase NCI funding, and has also lobbied for legislation to help people have greater access to early detection and prevention procedures. According to Dr. Freeman, all lobbying and research studies have one purpose—to assist the government in acting responsibly to aid those affected by cancer.

Michael Hudson, Attorney-at-Law, Austin, Texas:

Mr. Hudson represents various nonprofit organizations, including the People for the American Way and the Texas Maternal and Child Health Coalition.

Mr. Hudson's testimony cited situations where lobbying by nonprofit organizations provided valuable information to the legislature which otherwise would not have been provided, and which promoted the interests of the general public. He noted his belief that current tax laws, including the 1970 law, generally have worked well. The Texas Maternal and Child Health Coalition, according to Mr. Hudson, was formed to promote improved health care for medically indigent pregnant women and young children in Texas. The Coalition held meetings in communities throughout the State, prepared fact sheets and recommendations, and conducted an analysis of Texas hospital costs. The result was new funding at the Federal, State, and county levels for the 70,000 pregnant women living below the poverty level. Also, the Texas Public Interest Center has published a major study on the issue of Joint and Several Liability which contains recommendations not otherwise available to the Texas legislation for use during consideration of tort reform. Mr. Hudson concluded by noting private philanthropy should be encouraged in the true spirit of privatization.

Jack Moskowitz, Senior Vice President, Government Relations, United Way of America:

United Way of America is a nonprofit agency delivering service to the needy. The 2,200 United Ways in the United States collectively raised more than \$2.44 billion through voluntary contributions.

Mr. Moskowitz's testimony indicated the critical role United Way's volunteer community agencies play in government decision-making. He cited recent activity in Austin, Texas, where United Way worked with the city and county governments to operate a shelter for the homeless. He noted that on numerous occasions the agencies have been contacted by city and State officials to express the needs of the local community and also provide assistance to the government in addressing those needs.

Mr. Moskowitz concluded by stating the dialog between his agencies and city councils, school boards, and State legislatures is important in solving human problems that exist today.

Norma Phillips, National President, Mothers Against Drunk Driving:

M.A.D.D. is a section 501(c)(3) tax-exempt organization.

Ms. Phillips' testimony indicated M.A.D.D. relies on a broad based grassroots effort to advocate and implement public policies against alcohol and drug-impaired driving. There are over 600,000 volunteers. Ms. Phillips noted that since M.A.D.D.'s inception in 1980, over 700 anti-drunk-driving laws have been enacted, so clearly the grassroots efforts have been successful. According to Ms. Phillips, M.A.D.D. makes the section 501(h) election and has no trouble remaining within the limits because of the volunteer nature of the organization.

Ms. Phillips concluded by noting that M.A.D.D. is satisfied with current restrictions on lobbying and/or political activity and has been able to operate effectively within these laws.

Betty Williams, Director, Public Affairs, for the Indiana Planned Parenthood Affiliates Association:

Ms. Williams testified on behalf of the Indianapolis Coalition for Human Services, a section 501(c)(4) organization.

The Coalition, according to Ms. Williams, is an association of 33 organizations, mostly section 501(c)(3), working to develop and promote comprehensive human services for Indiana residents by influencing public policy and its implementation. Ms. Williams noted that the Coalition frequently provided assistance to the Indiana Legislature through research and testimony. Ms. Williams urged withdrawal of the proposed section 501(h) regulations due to the strong concern regarding the impact of the proposed regulations on both the Coalition's activities and the desire of foundations to contribute grants to members of the Coalition.

Alan P. Dye, Counsel, the Council on Non-Profit Organizations, Inc.:

The Council, according to Mr. Dye, is a newly formed coalition of charities, lobbying groups, and other nonprofit organizations. Mr. Dye's testimony focused on the areas of current law which pose difficulty for the organizations and corresponding recommendations to resolve those difficulties.

With regard to legislative activities, Mr. Dye indicated the uncertainty in defining an activity as lobbying and then measuring the amount of activity, especially when it is grassroots. Included in this is the definition of a legislative communication which is insufficiently clear. Mr. Dye noted the difficulty in imagining any public policy issue not likely to be the subject of legislation. Mr. Dye recommended elimination of the section 501(c)(3) limitation on grassroots lobbying communications, except for express advocacy of specific legislation. The same position is urged with respect to "action organization regulations" referred to in Treasury Reg. Sec. 1.501(c)(3)-1(c)(3). Furthermore, Mr. Dye recommended that any communication should be deemed educational so long as it does not urge its reader to take some legislative action with respect to spe-

cific legislation. Also, Mr. Dye indicated that any determination by the IRS that the "selective dissemination" of a communication is indicative of a legislative communication would be destructive to many organizations. Such a determination, according to Mr. Dye, is unreasonable in light of the fact that a mailing list usually consists of donors or others who request the information and therefore share the views of the organization. Also, for most organizations the potential cost of screening the lists is too burdensome. He *recommended* that any characterization of a communication must be based on content only, not based upon the identity or views of those who receive it.

Another problem noted by Mr. Dye was that once a determination has been made that the activity is a legislative communication, organizations not electing to be treated under section 501(h) must determine what is "substantial." He *recommended* specification of the quantity of legislative activity deemed to be "substantial" for non-electing organizations and definition of how the "substantiality" of the activity is to be measured. According to Mr. Dye, the "substantiality" should be measured as a percentage of expenditures devoted to the legislative activity.

With regard to political activities, Mr. Dye indicated uncertainty as to what is included in the prohibited activities. Mr. Dye *recommended* that political activity should only include communications or activity expressly supporting or opposing a candidate or party. The result, according to Mr. Dye, would be a discussion of public policy issues involving public officials without fearing loss of tax-exempt status.

Another problem noted by Mr. Dye was the inconsistency between tax law and election law. Mr. Dye *recommended* that section 501(c)(3) and section 501(h) become consistent with the Federal Election Campaign Act of 1971. Therefore, if an action is not a contribution or expenditure for F.E.C.A. purposes then it would not be considered an "exempt function expenditure" or "participation in any political campaign" for the purpose of sections 527 or 501.

Finally, with regard to affiliated organizations, Mr. Dye indicated that section 501(c)(4) serves as a safety valve for the uncertainties involved in section 501(c)(3), and expressed support for the continuation of current law based upon a belief that no policy justifies prohibiting the use of affiliated section 501(c)(3) and section 501(c)(4) organizations.

John W. Johnson, Chairman of the Board, American Society of Association Executives:

The American Society of Association Executives (ASAE) is an individual membership society, founded in 1920, which currently represents 14,000 executives who manage nearly 7,000 trade and professional associations. The organization estimates an overall constituency of more than 80 million individuals. Mr. Johnson is executive vice president of the American Collectors Association which is a nonprofit trade association with more than 3,300 corporate clients who provide debt collection service for 800,000 credit granters.

Mr. Johnson's testimony indicated that the ASAE's members primarily represent trade associations, usually tax-exempt under section 501(c)(6), and professional societies, many of which are tax

exempt under section 501(c)(3). The purpose of ASAE, according to Mr. Johnson, is to enhance professionalism of association executive members, to improve the performance of the voluntary membership organization they represent, and to assist these executives and organizations in dealing effectively with public policy issues. Mr. Johnson noted that ASAE has prepared studies on various aspects of association management which indicate a majority of associations are operating within the law.

With regard to lobbying activity, an ASAE 1985-86 report indicated that the average association spends less than 5 percent of its budget on government relations activities (the mid-point of the 450 associations surveyed was 1 percent), and two-thirds of associations do not employ a full time government relations staff person. Mr. Johnson cited the findings as supportive of the conclusion that a vast majority of organizations fulfill their purpose without engaging in an inordinate amount of lobbying or political activity. In that context, he noted ASAE's concern that the proposed section 501(h) regulations will constrict lobbying and hamper the ability of charities to perform research or inform members on public policy issues of general concern.

With regard to political activities, an ASAE 1982 report found that only 13 percent of associations operate a Federal level political action committee (PAC). Of the 196 PAC's responding to a 1985 survey, 70 percent were administered by trade associations and 30 percent were administered by other professional organizations. Only 16 percent of all respondents indicated they conduct independent expenditures on behalf of candidates. Mr. Johnson indicated the data, contrary to public perceptions, shows association PAC's have a broad base of support, donate reasonable amounts to candidates, and display bipartisanship while sponsoring the organization's educational or business mission. Mr. Johnson focused on two additional areas of public concern when he noted that, in ASAE's view, most independent expenditures are positive contributions by associations to the campaign process and "soft money" contributed by PAC's should be subject to full disclosure.

In conclusion, Mr. Johnson asserted ASAE's belief that changes in the current law are unwarranted.

FRIDAY, MARCH 13, 1987

Sheldon S. Cohen, Esq., Morgan, Lewis and Bockius, Former IRS Commissioner (1965-69):

Mr. Cohen concurred with other witnesses that there must be more appropriate remedies to forbid activities than denial of exempt status, such as possible excise taxes similar to those on private foundations.

He then concentrated on the political uses of section 501(c)(3) entities, identifying situations in which there is a need for additional regulation. Mr. Cohen *recommended* that consideration be given to applying the section 509(a)(3) "supporting organization" term as a fair and administrable standard in the political foundation area by merely substituting the term "political figure" for "the established public charity." In section 509(a)(3) the law looks to the degree of control exercised by the public charity over the supporting organi-

zations, and to the "responsiveness" of the supporting organization to the public charity.

Mr. Cohen observed that in the area of political activity and lobbying by section 501(c)(3) organizations, he is afraid that bad practice is driving out the good. We must find ways, he went on to say, of making the IRS effective in policing the activities of these organizations which attempt to operate at the outer limits of what is acceptable. In order to do this, Congress must assist the IRS with more clearly articulated rules and definitions.

John Buchanan, Chairman, People for the American Way:

Mr. Buchanan described the operations of his organization, a nonpartisan public interest organization of 250,000 members dedicated to the protection and preservation of constitutional liberties in the United States. He stated that "People For" was established as a section 501(c)(3) educational organization and plays a leading role in defending and promoting religious freedom, the freedom to learn, public education, equal justice, an independent judiciary, and free and open debate. Mr. Buchanan described how in 1984 a section 501(c)(4) organization was established so that public policy activity could be expanded while ensuring that the section 501(c)(3) status of the original organization would not be jeopardized.

"People For" agrees that section 501(c)(3) organizations should not be permitted to engage in political activities. Mr. Buchanan, however, urged that the nonprofit sector's participation in public policy formation through lobbying activities should be encouraged and promoted. The nonprofit community makes a unique and invaluable contribution in the information it provides to Congress, and State and local legislators. He expressed fear that restricting the flow of ideas and information from public charities will produce a government isolated from the governed.

Edwin J. Feulner, Jr., Ph.D., President, the Heritage Foundation:

Dr. Feulner stated that the Heritage Foundation, as a research institution, does not engage in propaganda or otherwise attempt to influence legislation or engage in political campaign activities. Even having said that, Dr. Feulner pointed out, it does not mean that the Foundation is necessarily in complete compliance with existing law because no one knows what constitutes "substantial" lobbying activity. Further, Dr. Feulner suggested that section 501(h) is an unmitigated failure since less than 1 percent of the public sector has elected to come under its provisions.

Dr. Feulner urged repeal of the lobbying rules, which would signal a new openness, a welcomeness—to charities, to schools, to educational institutions, and to churches, to assume a rightful role in the legislative area.

Jackie A. Strange, President and Chief Executive Officer, the Dole Foundation for Employment of Persons With Disabilities:

Ms. Strange stated that the Dole Foundation is a nonpartisan section 501(c)(3) organization, whose mission is to promote the economic independence of persons with disabilities. It is not a so-called "political foundation," nor does it engage in lobbying or advocacy activities.

The Dole Foundation was described further: (a) created in 1984 by U.S. Senator Robert Dole as a means of returning to society the type of rehabilitative support he received from his hometown of Russell, Kansas, during his own struggle with a disability following World War II; (b) a "passthrough" organization that raises money and in turn awards grants (totaling \$1,150,000 to date) to local non-profit organizations that operate innovative programs to help disabled persons gain economic independence; (c) governed by a 17-member board of trustees, chaired by Senator Dole, with Robert S. Strauss as vice chairman; and (d) does not pay the travel expenses of, or share mailing lists with, Senator Dole.

Hon. Martha Keys, Executive Director, Center for a New Democracy:

Ms. Keys has been executive director of this section 501(c)(3) research and education organization for the past 2 years.

Ms. Keys expressed her belief that, while the strictest safeguards should be instituted to guard against abuses, research centers associated with political leaders can make an important contribution to the public policy debate. The public interest is well served by the ability of such work to take the long-range view, to explore new options and to allow a wide range of experts to work together to develop solutions.

The Center for a New Democracy has a policy of disclosing both its contributors and a financial report of its receipts and expenditures in an annual report. Ms. Keys *recommended* this practice as a reasonable requirement for all section 501(c)(3) organizations founded by or closely associated with a political leader.

John R. Wallace, Counsel, North Carolina Democratic Party:

Mr. Wallace addressed the political activities of tax-exempt organizations and presented his evidence on certain organizations in North Carolina that are affiliated with the National Congressional Club of Senator Jesse Helms, particularly the Coalition for Freedom, the Educational Support Foundation, and the Congressional Club Foundation.

Mr. Wallace went on to describe the complaint filed by Congressman Charles Rose (D., N.C.) with the Federal Election Commission concerning the practices of the National Congressional Club and Jefferson Marketing, Inc., in 1982 which led to a consent decree entered into among Jefferson Marketing Inc., National Congressional Club, and the FEC in 1986. Questions about subsequent years were also mentioned.

It is Mr. Wallace's belief that the complex network of affiliated organizations exists to promote and advance political careers, with the intention of evading the Federal Election Campaign Act and the Internal Revenue Code. He pointed out the limits to the FEC's jurisdiction and the practical limits on the FEC's ability to address the activities of affiliated section 501(c)(3) and 501(c)(4) organizations. Mr. Wallace also questioned whether the Internal Revenue Service had undertaken any review. He concluded that an examination of these organizations and their affiliations demonstrates the need for closer scrutiny under existing law or perhaps the need for legislative changes to address the present political environment.

Paul S. Egan, Deputy Director, National Legislative Commission, the American Legion:

Mr. Egan described the historical development of the unique treatment veterans organizations receive pursuant to section 501(c)(19). Contributors to section 501(c)(19) veterans organizations, which engage in substantial lobbying and some political activities, are tax-deductible, unlike contributions to section 501(c) (4), (5), or (6) organizations.

The American Legion engages in no political activity (as prohibited by its congressional charter) and undertakes only modest lobbying. Of the Legion's total operating budget, 1.4 percent is explicitly allocated to lobbying activity, most of which involves responding to congressional requests for testimony.

The American Legion is satisfied with the tax law classification of section 501(c)(19) in its current form and believes that its special status should be retained.

John F. Heilman, National Legislative Director, Disabled American Veterans:

Mr. Heilman described the goals, programs and services of this 1.1 million membership organization. Formed by a group of disabled World War I veterans in 1920, it received a congressional charter in 1932 and is tax-exempt under section 501(c)(4).

The most important program of the DAV is its National Service Program. The DAV also administers a National Legislative Program, the purpose of which is to initiate and support legislation beneficial to this country's veterans, their dependents and survivors, in terms of their entitlement to Federal benefits and services predicated upon military service.

Mr. Heilman stated that DAV expenditures related to legislative/lobbying activities at the Federal level do not comprise a significant portion of the organization's revenues: lobbying expenditures in 1986 amounted to six-tenths of 1 percent of total revenues. DAV is satisfied with the standards set forth in current law.

James N. Magill, Director, National Legislative Service, Veterans of Foreign Wars' of the United States:

Mr. Magill described the objectives, projects and programs of this 2.7 million membership organization, which is federally chartered and tax-exempt under section 501(c)(19). One of the Veterans of Foreign Wars' primary goals is to protect and enhance those benefits and entitlements veterans have earned. The VFW confines its lobbying activities to only areas which serve veterans, their dependents, and survivors.

The organization believes its status under section 501(c)(19) does meet the needs of the VFW and is appropriate.

Robert O. Bothwell, Executive Director, National Committee for Responsive Philanthropy:

The National Committee for Responsive Philanthropy is a section 501(c)(3) public charity organized to encourage greater openness, information, and accessibility of funding in private philan-

thropy. The committee has also elected under section 501(h) to determine its permissible lobbying limits.

Mr. Bothwell described in detail the operations and objectives of the committee which include lobbying and grassroots lobbying. He concluded that section 501(h) was a tremendous jump forward in moving away from the vague and arbitrary "substantial" test for acceptable lobbying. Mr. Bothwell provided the subcommittee with a full set of documents on the organization in the interest of helping the subcommittee understand this one organization's work within the admirable structure of section 501(h) of the Code.

Joseph W. Blackburn, Counsel, Coalition of Health Care Organizations, Birmingham, Alabama:

Mr. Blackburn testified that the common law and existing Code provisions provide ample restraint on the political or other nonexempt activities of section 501(c)(3) organizations. He pointed out that the fact that a tax-exempt organization is a link in a chain leading toward a political or nonexempt goal does not in any way mean that the tax-exempt organization's activities are improper.

Mr. Blackburn *recommended* reliance on existing laws and existing systems of enforcement, in general. However, he did mention that consideration should be given to utilizing a wider range of available penalty provisions as well as to expanding civil penalties (including restitution) for persons controlling tax-exempt organizations who violate the public trust. Certainly, Mr. Blackburn concluded, use of a tax-exempt organization to circumvent Federal election laws should be addressed in such Federal election laws, not the Internal Revenue Code.

James Lescault, Executive Director, Urban Educational Systems, Inc., Jamaica Plain, Massachusetts:

Urban Educational Systems, Inc. (UES), is a section 501(c)(3) non-profit organization organized principally to assist in and advance arson prevention and neighborhood stabilization.

Mr. Lescault described the steps UES has taken to successfully alter previously held beliefs regarding arson and fire and promote a proactive prevention through the advocacy for structural changes at the Federal, State, and local levels. UES, once successful in institutionalizing a new mode in preventive strategies at the Federal level, then proceeded to provide technical assistance to other community-based organizations. UES informed these organizations about section 501(h) and stressed how these organizations were entitled to lobby for their constituents and communities. He went on to describe how, with this law, many tax-exempt, community-based organizations pursued the issue of arson and fire prevention through their local, State, and Federal legislative bodies.

Mr. Lescault concluded that although this is only one issue, it is exemplary of the type of approach and process many creative and dedicated persons use in attempts to facilitate and implement a truly democratic system open to new ideas and connected to the neighborhoods across the country.

IV. LEGISLATIVE HISTORY OF PROVISIONS RELATING TO THE LOBBYING AND POLITICAL ACTIVITY OF TAX-EXEMPT ORGANIZATIONS

REVENUE ACT OF 1934: LEGISLATIVE ACTIVITY

The first legislation enacted in this area was contained in the Revenue Act of 1934,¹ which included a provision prohibiting deductions for contributions to section 501(c)(3) type organizations where a "substantial part of the activities [of the organization] is carrying on propaganda, or otherwise attempting, to influence legislation." The amendment was recommended by the Senate Finance Committee² and added on the Senate floor.³ As recommended by the Senate Finance Committee and adopted originally by the Senate, the language of the prohibition also extended to "participation in partisan politics." That language was removed in conference so that the final limit was directed toward lobbying activities.⁴ As the excerpts from the floor debate suggest, there was apparently a twofold policy concern. First, it seems that the sponsors believed that some organizations were engaged in lobbying campaigns using tax deductible contributions and that this was inappropriate (not charitable) behavior. Second, the debate reflects concern over how language could be drafted to permit what was seen as appropriate activity (presumably viewed as educational) while limiting excesses.

While the legislative history is sparse and does not clearly establish the congressional rationale in the enactment of the provision, the thrust of the limitation seems consistent with the pre-1934 position of the Internal Revenue Service that legislative activity was not a tax-exempt charitable purpose.⁵ It may also be to some extent a reflection of the views expressed by Judge Learned Hand in *Slee v. Commissioner*⁶ some 4 years earlier. There the court upheld a decision of the United States Board of Tax Appeals disallowing a charitable deduction for contributions to the American Birth Control League. While acknowledging that a charity may seek to influence legislation and still retain its charitable character (for example a university seeking an appropriation, an organization seeking a special charter, or a society to prevent cruelty to children seeking positive support of law to achieve its ends), Judge Hand found such activity legitimately consistent with the appellation charitable only where the legislative activity is "ancillary to the end in chief." Where enactment or repeal of legislation has become

¹ Revenue Act of 1934, sec. 517, 48 Stat. 760.

² S. Rep. No. 558, 73d Cong., 2d sess. at 26.

³ 78 Cong. Rec. 5959.

⁴ H. Rep. No. 1385, 73d Cong. 2d sess. at 17.

⁵ T.D. 704, 3 C.B. 240 (1920); S. 1362, 2 C.B. 152, 154 (1920).

⁶ 42 F.2d 184 (2d Cir. 1930).

a primary purpose, however, the organization no longer exclusively operated for a charitable purpose, and Congress did not intend for the charitable deduction to be used to assist such activities. An examination of Judge Hand's opinion reveals the same difficult struggle in drawing lines between charitable, educational, and lobbying activities in this judicial decision that Congress faced 4 years later in examining statutory language.

INTERNAL REVENUE CODE OF 1954: POLITICAL ACTIVITY

As noted above, the Senate had approved language limiting political activity in 1934. That language was eliminated in conference. In 1954, while H.R. 8300 (83d Cong.) (1954 I.R.C.) was under consideration on the Senate floor, Senator Lyndon B. Johnson offered an amendment to section 501(c)(3) effectively denying tax-exempt status to organizations intervening in campaigns on behalf of candidates. The amendment was accepted without debate or discussion.⁷ No corresponding changes were made in the provisions governing deductions. However, in 1958, regulations were adopted under section 170 expressly denying an income tax deduction for contributions to an organization participating or intervening in a political campaign on behalf of any candidate.⁸ As noted below, the statutory language was itself modified to include this limit as part of the Tax Reform Act of 1969.⁹ While the legislative history is silent, one secondary source indicates that Senator Johnson may have been motivated by a belief that a private foundation had provided some indirect financial support for an election opponent.¹⁰

1975—PUBLIC LAW 93-625 AND THE POLITICAL ORGANIZATION EXEMPTION

On January 3, 1975, President Ford signed H.R. 421 into law (Public Law 93-625). This law included several provisions of significance to political activity and exempt status under present law.¹¹ Of particular import, it added section 527 to the Internal Revenue Code. That section provides, among other things, for tax-exempt status for political parties, committees, associations, funds, or other organizations (incorporated or not) organized and operated primarily for the purpose of (directly or indirectly) accepting contributions or making expenditures to influence the selection, election, or appointment of an individual to public or political office.¹²

The Senate Finance Committee report apparently recognizes that exempt organizations which are not political organizations will and can create separate political organizations. Indeed, this seems to have been intended. It seems equally clear, however, that it did not intend to affect the prohibition against electioneering by section

⁷ 100 Cong. Rec. 9604; the discussion in the debate and conference report (H. Rep. No. 2543, 83d Cong., 2d sess.) simply describe the amendment in capsule form.

⁸ T.D. 6285, 1985-1 C.B. 127.

⁹ Public Law 91-172, sec. 201(a)(1)(B), 83 Stat. 553.

¹⁰ Hopkins, *The Law of Tax-Exempt Organizations* (4th ed.) 247 (1983); he does not cite a source.

¹¹ Provisions relating to the limited deduction or credit for political contributions, to newsletter funds, or income tax treatment of gifts of appreciated property to political organizations are not discussed.

¹² Public Law 93-625, sec. 10, 88 Stat. 2116 (codified at I.R.C. sec. 527).

501(c)(3) organizations. It is doubtful that the committee foresaw the degree of activity or the extent of the interaction which appears to characterize the relationship between section 501(c)(3)'s, other 501(c)'s, and PAC's today.

TAX REFORM ACT OF 1976—PUBLIC LAW 94-455

The Tax Reform Act of 1976 added sections 501(h) and 4911 to the Internal Revenue Code. These sections permit certain section 501(c)(3) organizations to elect to replace the "substantial part of activities" test with a limit defined in terms of expenditures for influencing legislation.

This provision was adopted by the House as part of H.R. 13500 (not part of the tax reform bill). The Senate incorporated provisions, similar to those in H.R. 13500, in the tax reform bill. The Senate version of the bill was adopted in conference, but the conference report makes it clear that the conferees intended to specifically incorporate the House report by reference except for one paragraph.

The House Committee on Ways and Means report indicated that the committee had amended the bill before reporting it. It summarized the bill as providing a new elective set of requirements for determining whether a charitable organization (other than churches, church organizations, and private foundations) has engaged in excessive lobbying activities sufficient to cause it to lose its exemption and qualification for receiving deductible contributions.¹³

The report explained the reason for the bill was that, except for private foundations, the only sanctions for excessive lobbying were loss of exemption or loss of qualification to receive deductible contributions. Some organizations (especially those with substantial endowments) could split up their activities between a lobbying organization and a charitable organization. For those groups, the restrictions had little effect and may have discouraged enforcement. For organizations which could not do that, loss of exemption would be a severe blow. The bill tried to remedy this problem by providing explicit limits keyed to the size of the organization, and a penalty equal to 25 percent of the excessive lobbying expenditures. Revocation was reserved for those cases where excessive lobbying occurs over a period of time. H.R. 13500 was passed by the House 355-14 on June 8, 1976.¹⁴

The Senate Committee on Finance Report¹⁵ was issued July 20, 1976. It offers the same reasons for the change that the House offered in its report on H.R. 13500. The Senate does not appear to have amended this provision on the floor. The conference report indicates that the Senate version of the bill was adopted.¹⁶ The provision was contained in section 2503 of the bill and primarily added sections 501(h) and 4911 to the Internal Revenue Code.¹⁷

¹³ H. Rep. No. 1210, 94th Cong., 2d sess. 7 (1976).

¹⁴ 122 Cong. Rec. 16891 (June 8, 1976).

¹⁵ S. Rep. No. 938, Pt. 2, 94th Cong., 2d sess. 79-85 (1976).

¹⁶ S. Rep. No. 1236, 94th Cong., 2d sess. 532-534 (1976).

¹⁷ Public Law 94-455, sec. 2503.

V. DEFINITIONS OF LOBBYING AND POLITICAL ACTIVITY

A. LOBBYING ACTIVITY

In general, a section 501(c) organization is engaged in lobbying activity if it advocates the adoption or rejection of legislation. For this purpose, the term "legislation" includes action by Congress or any State or local legislative body, or by the public in a referendum, initiative, constitutional amendment, or similar procedure.¹ It makes no difference whether the legislation is beneficial to the community.² The main issues involved in determining what constitutes lobbying are determining (1) what is an attempt to influence legislation, or an allowable exception to the definition, and (2) when a lobbying activity is treated as the activity of a particular organization.

ATTEMPTING TO INFLUENCE LEGISLATION

Lobbying includes such activities as (1) directly contacting members of a legislative body (or their staffs) to propose, support, or oppose legislation,³ (2) grassroots lobbying (urging the public to contact legislators or legislative staffs to propose, support, or oppose legislation), and (3) more generally, advocating the adoption or rejection of legislation.

There are a number of circumstances, however, in which commenting on proposed legislation is not treated as lobbying. For section 501(c)(3) purposes, when an organization not otherwise involved in taking a position with regard to legislation engages in nonpartisan analysis thereof, and communicates its analysis to legislators, the organization nonetheless is not engaged in lobbying if it takes no position (e.g., it merely gathers relevant materials and data not calculated to support a particular position).⁴

A somewhat different rule may apply under section 4945 (the regulatory excise tax for political activities by private foundations). For purposes of this provision, nonpartisan analysis may express a particular viewpoint, without constituting lobbying, "as long as there is a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion."⁵

Under the various relevant Code provisions, an organization is not engaged in lobbying if, in response to a formal request for assistance by a legislative body, it provides technical advice or assist-

¹ Treas. Reg. sec. 1.501(c)(3)-1(c)(3)(ii).

² See, e.g., Revenue Ruling 67-293, 1967-2 C.B. 185.

³ Requesting an executive body to support or oppose legislation also constitutes lobbying. See, e.g., Revenue Ruling 67-293, 1967-2 C.B. 185.

⁴ See, e.g., Revenue Ruling 64-195, 1964-2 C.B. 138.

⁵ Treas. Reg. sec. 53.4945-2(d)(1)(iii).

ance.⁶ Moreover, for purposes of section 4911 (relating to lobbying activities by a section 501(c)(3) organization that elects the application of section 501(h)), an organization is not treated as lobbying if it communicates with its bona fide members regarding issues of direct interest to the organization and such members, so long as the communications do not directly encourage such individuals to engage in lobbying.⁷

For purposes of section 4945 (the regulatory excise tax on private foundations), lobbying does not include discussions of broad social, economic, and similar problems, even when such discussions are communicated to legislators who are considering legislation relating to such broad problems. However, this exception does not apply unless the discussion does not specifically address the proposed legislation.⁸

Further, lobbying may not include certain activities that are directly in the self-interest of the exempt organization itself. For example, "self-defense" is not lobbying, at least for purposes of sections 4911 and 4945. For this purpose, "self-defense" means appearing before, or communicating with, a legislature regarding legislation that might affect the organization's existence, powers and duties, tax-exempt status, or the deduction of contributions to the organization.⁹ Moreover, lobbying may not include soliciting government funds for the organization's programs.¹⁰

TREATING A LOBBYING ACTIVITY AS THE ACTIVITY OF A PARTICULAR ORGANIZATION

With lobbying activities, as with political activities, issues may arise regarding whether the activity of a particular member is attributable to the organization. Similar attribution principles apply in the two contexts.

For lobbying purposes, an additional issue of responsibility for particular activities arises. The issue relates to the rules of section 4911 that provide dollar limitations on the amount that a section 501(c)(3) organization can spend on lobbying if it elects the application of section 501(h).

In order to prevent organizations from avoiding these dollar limitations by dividing themselves into technically separate but related entities, section 4911(f) provides affiliation rules. Under these rules, related organizations each of which has elected the application of section 501(h) may be treated as a single organization, for section 4911 purposes.

In general, affiliation is found where organizations are subject to common control. For example, if one organization is required by its governing instrument to be bound by decisions of another organization, then the two organizations are treated as affiliated.¹¹ Affiliation likewise is found where the governing board of one organization is controlled, for practical purposes, by designated representa-

⁶ Section 4911(d)(2)(B); section 4945(e)(2). See also Revenue Ruling 70-449, 1970-2 C.B. 111 (interpreting the general rule for organizations described by section 501(c)(3)).

⁷ Section 4911(d)(2)(d).

⁸ Treas. Reg. sec. 53.4945-2(d)(4).

⁹ Section 4911(d)(2)(C); section 4945(e).

¹⁰ Treas. Reg. sec. 53.4945-2(a)(3); *Slee v. Commissioner*, 42 F.2d 184 (2d Cir. 1930).

¹¹ Section 4911(f)(2)(A).

tives, board members, officers, or paid executive staff members of a second organization.¹² Rules also apply to aggregate lobbying expenditures by different organizations where there is limited affiliation; i.e., one organization controls another solely with regard to national legislation.¹³

B. POLITICAL ACTIVITY

In general, a section 501(c) organization is engaged in political activity if it participates or intervenes, directly or indirectly, in any political campaign on behalf of or in opposition to any candidate for public office.¹⁴ The main issues involved in interpreting this rule are determining (1) who is a candidate in a political campaign, (2) what constitutes intervention in a campaign, and (3) when such intervention is attributed to a particular organization.

CANDIDATES IN POLITICAL CAMPAIGNS

In general, a candidate is "an individual who offers himself, or is proposed by others, as a candidate for an elective public office."¹⁵ The office involved can be national, State, or local.¹⁶ In order to meet this definition, however, it is not required that the election be contested or involve the participation of political parties.¹⁷

Clear standards do not exist for determining precisely at what point an individual becomes a candidate for purposes of the rule. On the one hand, once an individual declares his candidacy for a particular office, his status as a candidate is clear. On the other hand, the fact that an individual is a prominent political figure does not automatically make him a candidate, even if there is speculation regarding his possible future candidacy for particular offices.

Two recent lawsuits that currently are pending also concern allegations of political activity by section 501(c)(3) organizations.¹⁸ In both cases, the Federal Government, as defendant, is accused of not enforcing the ban on political activity by section 501(c)(3) organizations.

INTERVENTION IN A POLITICAL CAMPAIGN

The determination of what constitutes intervention in a political campaign requires weighing all relevant facts and circumstances.¹⁹ Section 501(c)(3) mentions "the publishing or distributing of statements" that support or oppose a candidate as an example of intervention. Other clear examples would include making or soliciting campaign contributions, providing publicity or volunteer assistance, and paying expenses of a political campaign.

¹² Section 4911(f)(2)(B).

¹³ Section 4911(f)(4).

¹⁴ Section 501(c)(3); Treas. Reg. sec. 1.501(c)(3)-1(c)(3)(iii).

¹⁵ Treas. Reg. sec. 1.501(c)(3)-1(c)(3)(iii).

¹⁶ Id.

¹⁷ Revenue Ruling 67-71, 1967-1 C.B. 125.

¹⁸ *Keane v. Baker*, No. 86-0588E (W.D.N.Y.), June 19, 1986 (alleging that a section 501(c)(3) organization was assisting the plaintiff's opponent in a political campaign); *Abortion Rights Mobilization, Inc. v. Baker*, No. 86-6092 (pending in the Second Circuit, and concerning whether the Catholic Church has engaged in political activity by opposing candidates who support the allowability of abortion).

¹⁹ See e.g., Revenue 78-248, 1978-1 C.B. 154.

Endorsing a candidate for public office constitutes intervention in a political campaign.²⁰ In this respect, it does not matter that an organization's endorsement is asserted to have been based on neutral assessments of candidates' professional, intellectual, or ethical qualifications, rather than on partisan grounds.²¹ Opposing a candidate also constitutes intervention, even if the organization does not endorse the candidate's opponents.²²

In many cases, the critical issue in determining whether an activity constitutes intervention in a political campaign is whether it reflects or advances a preference as between competing candidates. Neutral efforts to educate voters are not treated as intervention, but an effort that is neutral on its face may in fact be biased, and accordingly constitute political activity.

In a 1978 revenue ruling, the Internal Revenue Service gave several examples illustrating the distinction between neutral voter education and political activity.²³ In one example, an organization published compilations of the voting records of all Members of Congress on major legislative issues involving a wide range of subjects. The publications contained no editorial opinion, and did not imply any viewpoint regarding particular Members or issues. The publication was held not to be a political activity. Similarly, an organization that, during a political campaign, published statements of positions on a wide range of issues by all of the candidates was held not to be intervening.

However, an organization that circulated responses by candidates to a questionnaire was held to be intervening in a campaign where the questions evidenced a bias on particular issues. An organization that publicized candidates' viewpoints only on a narrow range of issues also was held to be intervening.²⁴

A special rule defining political activity applies to private foundations with regard to the application of the regulatory excise tax under section 4945. Involvement by a private foundation in voter registration activities is not considered political activity, for section 4945 purposes, if, among other requirements, the activities are non-partisan, not confined to one specific election period, carried on in five or more States, and supported by broad-based donor contributions.²⁵

ATTRIBUTION OF POLITICAL ACTIVITIES TO AN ORGANIZATION

Where members of an organization are involved in political activities, it is necessary to determine whether such activities are attributable to the organization, or instead are undertaken independently by the individuals in their private capacities. In general, principles of agency are relevant to this determination. For example, acts undertaken by individuals under actual or purported au-

²⁰ See, e.g., G.C.M. 39941 (November 7, 1985).

²¹ See G.C.M. 39941 *supra* (organization that rated judgeship candidates as "Approved," "Not Approved," or "Approved as Highly Qualified" was intervening in political campaigns even though ratings were given on a nonpartisan basis); Revenue Ruling 76-456, 1976-2 C.B. 151 (organization that asked candidates to sign a code of fair campaign practices, and released the names of candidates who signed and refused to sign, was intervening in political campaigns).

²² See e.g., *Christian Echoes National Ministry*, *supra*.

²³ Revenue Ruling 78-248, 1978-1 C.B. 154.

²⁴ *Id.*

²⁵ Section 4945(f).

thority to act for the organization, and acts planned or ratified by the organization are considered activities of the organization.²⁶ Where an exempt organization uses a business subsidiary as a "guise" for carrying out particular activities without restriction, the subsidiary's activities are attributed to the parent.²⁷

²⁶ See G.C.M. 34631 (October 4, 1971).

²⁷ See G.C.M. 33912 (August 15, 1968).

VI. SUMMARY OF PRESENT LAW APPLICABLE TO LOBBYING AND POLITICAL ACTIVITIES BY TAX-EXEMPT ORGANIZATIONS

A. CHARITABLE, RELIGIOUS, SCIENTIFIC, ETC. ORGANIZATIONS (SECTION 501(c)(3) ORGANIZATIONS)

Code section 501(c)(3) provides that an organization may be exempt from Federal income tax (and can receive charitable contributions that are deductible by donors)¹ if, among other requirements, it is "organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes."² Typical examples of section 501(c)(3) organizations include nonprofit universities, hospitals, scientific journals, churches, and groups engaged in aid to the poor.³

An organization cannot qualify under section 501(c)(3) unless "no substantial part of [its] activities * * * is carrying on propaganda, or otherwise attempting, to influence legislation, * * * and [the organization] does not participate in, or intervene in (including the publishing or distributing of statements) any political campaign on behalf of any candidate for public office."

The rule that section 501(c)(3) organizations cannot engage in substantial lobbying activities has been in the Internal Revenue Code since 1934. Such organizations have been forbidden to engage in any political campaign activity since 1954.

1. General rule for section 501(c)(3) organizations

Since section 501(c)(3) organizations are not allowed to engage in any political campaign activities, the principal issue presented by the ban is, simply, the definition of such an activity. With respect to lobbying activities, however, a second issue exists. Lobbying activities lead to denial of tax-exempt status under section 501(c)(3) only if they are substantial in relation to the organization's other activities. Thus, it is necessary not only to determine the definition of such an activity, but also to determine the definition of the term "substantial."

The statute does not explain the meaning, in this context, of the term "substantial." There is no precise mechanical rule for determining the substantiality of an organization's lobbying activities in relation to its other activities. In particular, an arithmetical percentage test (e.g., looking at the percentage of the budget, or of em-

¹ Section 170(a).

² An organization also can qualify under section 501(c)(3) if it is organized and operated exclusively to foster national or international sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals.

³ An organization cannot qualify under section 501(c)(3) unless no part of the organization's net earnings inures to the benefit of any private shareholder or individual.

ployees' time, spent on lobbying), while relevant, has been held not determinative.⁴

To the extent that such a test is relevant, the percentage of the organization's expenditures or time that can relate to lobbying without endangering the exemption may be relatively small. For example, while an organization that spent less than 5 percent of its time on lobbying activities was held not to be substantially involved therein,⁵ the fact that another organization spent about 20 percent of its budget on lobbying activities contributed significantly to the court's finding of substantial involvement.⁶

The reason for not looking solely at the percentage of time or money spent by an organization on lobbying is that such a focus "obscures the complexity of balancing the organization's activities in relation to its objectives and circumstances."⁷ For example, an organization's budget may give an incomplete picture to the extent that it does not reflect the volunteer time and publicity devoted to lobbying activities by the organization, and the continuous or intermittent nature of the organization's involvement in the activities.⁸

In addition, even aside from weighing efforts not reflected in the budget that are devoted to lobbying, substantiality can be found because of the nature of the organization and its aims. Longstanding Treasury regulations state that an organization will be treated as an "action" organization (i.e., one not qualifying under section 501(c)(3) by reason of its involvement in lobbying) if its main or primary objective or objectives can be accomplished only by legislation or by the defeat of proposed legislation.⁹ For example, an organization that studied disparities in the Federal and State tax treatment of different types of business organizations, with the aim of achieving tax revisions that would remove the disparities, was held to be engaged in lobbying.¹⁰

2. Effect of making an election under section 501(h)

The absence of precise rules for determining when an organization's lobbying activities are "substantial" can give rise to uncertainty regarding the application of section 501(c)(3). An organization that wishes to engage in lobbying without losing its exempt status may have difficulty in determining exactly how much lobbying it can engage in.

The vagueness of the substantiality standard also was viewed as impeding the Internal Revenue Service in its efforts to enforce the requirements of section 501(c)(3) in a neutral and effective

⁴ See *Seasongood v. Comm'r*, 227 F.2d 907 (6th Cir. 1955), (where less than 5 percent of an organization's time and effort were spent on lobbying activities, such activities were not substantial in relation to the organization's other activities); *Haswell v. United States*, 500 F.2d 1133 (Ct. Cl. 1974), cert. denied, 419 U.S. 1107 (1975) (the fact that an organization spent between 16.6 percent and 20.5 percent of its budget on lobbying provided a strong indication of substantiality).

⁵ *Seasongood*, supra. This case subsequently has been questioned on this issue. See *Christian Echoes National Ministry, Inc. v. United States*, 470 F.2d 849 (10th Cir. 1972), cert. denied, 414 U.S. 864 (1973).

⁶ *Haswell*, supra.

⁷ *Christian Echoes National Ministry*, supra.

⁸ G.C.M. 36148 (January 28, 1975).

⁹ Treas. Reg. sec. 1.501(c)(3)-1(c)(3)(iv).

¹⁰ *Roberts Dairy Co. v. Comm'r*, 195 F.2d 948 (8th Cir. 1952), cert. denied, 344 U.S. 865 (1952). See also Revenue Ruling 62-71, 1962-1 C.B. 85 (organization that adopted a doctrine or theory that could become effective only upon enactment found to be an action organization).

manner.¹¹ Without a precise means of determining which organizations were lobbying excessively, it was difficult to determine how enforcement efforts should be allocated. Moreover, the lack of any intermediate penalty for excessive lobbying, short of denying the exemption, meant that slight differences in the amount of lobbying conducted could lead to major differences in tax treatment (i.e., revocation of tax-exempt status).

In 1976, Congress responded to these issues by enacting section 501(h). Under this provision, certain organizations seeking to qualify under section 501(c)(3) can elect to have the amount of lobbying in which they may engage measured under a precise arithmetical test, rather than just the general "substantiality" standard. Exemption under section 501(c)(3) may be denied to an electing organization where its lobbying activities exceed the arithmetical limit set forth in section 501(h). A lesser level of excessive lobbying expenditure by an organization electing the application of section 501(h) gives rise to a penalty excise tax under section 4911, but not to revocation of the underlying tax exemption. Separate limits are provided for direct lobbying and grassroots lobbying.

The following types of section 501(c)(3) organizations cannot elect the application of section 501(h): (a) churches (along with conventions or associations of churches, and certain organizations auxiliary to, or associated with, churches);¹² (b) certain organizations whose purpose involves supporting organizations exempt under section 501(c)(4), (5), or (6);¹³ (c) organizations engaged in testing for public safety;¹⁴ and (d) private foundations.¹⁵

Section 4911 defines the amount of lobbying in which an organization electing the application of section 501(h) can engage without any penalty whatever. This amount (referred to as the "lobbying nontaxable amount") varies with the amount of exempt purpose expenditures incurred by the organization during the taxable year.¹⁶ The lobbying nontaxable amount for direct lobbying equals 20 percent of the first \$500,000 of exempt purpose expenditures, plus 15 percent of the second \$500,000, plus 10 percent of the third \$500,000, plus 5 percent of any additional exempt purpose expenditures. However, in no event can the lobbying nontaxable amount exceed \$1 million.

Section 4911 also contains a limit on grassroots expenditures applying to organizations that elect the applicability of section 501(h). Grassroots expenditures are defined as lobbying expenditures that are directed at influencing public opinion, rather than at influencing legislative bodies, their employees, or other government officials. Under section 4911, the amount of grassroots expenditures that an organization can incur without penalty (referred to as the

¹¹ See Joint Committee on Taxation, "General Explanation of the Tax Reform Act of 1976," 1976-3 C.B. (Vol. 2) (henceforth, "General Explanation of 1976 Act") at 419-20.

¹² See sections 170(b)(1)(A)(i), 508(c), 6033, and 4911(f)(2). Churches were made ineligible for the section 501(h) election at their own request. See General Explanation of 1976 Act, at 427.

¹³ See section 509(a)(3).

¹⁴ See section 509(a)(4).

¹⁵ See section 509. Special rules applying to private foundations are described below.

¹⁶ For purposes of section 4911, exempt purpose expenditures are defined as expenditures to accomplish the organization's exempt purposes, including properly allocable salary payments, overhead, and all lobbying expenditures (whether or not related to an exempt purpose).

"grassroots nontaxable amount") is 25 percent of the amount of lobbying expenditures that can be incurred without penalty.

Whenever an organization's expenditures for a taxable year exceed the lobbying nontaxable amount, or the grassroots nontaxable amount, a penalty tax under section 4911 is imposed. This tax is equal to 25 percent of the amount of the excess lobbying expenditures (i.e., the excess overall lobbying or the excess grassroots lobbying, whichever excess is greater in comparison to the applicable limitation).

For example, assume that in a particular taxable year an organization has exempt purpose expenditures of \$2 million. The lobbying nontaxable amount equals \$250,000, and the grassroots nontaxable amount is \$62,500. The organization's lobbying expenditures for the year total \$330,000, of which \$130,000 are grassroots expenditures. The taxpayer's expenditures exceed the lobbying nontaxable amount by \$80,000 (\$330,000 minus \$250,000), and exceed the grassroots nontaxable amount by \$67,500 (\$130,000 minus \$62,500). The greater of these two numbers, or \$80,000, is subject to the penalty tax. Accordingly, in this case, the amount of penalty tax imposed would be \$20,000.

Excess lobbying or grassroots expenditures, in addition to giving rise to the penalty tax under section 4911, can under some circumstances lead ultimately to the denial of an organization's exemption under section 501(c)(3). Section 501(h) establishes ceiling amounts on lobbying and grassroots expenditures, equal to 150 percent of the nontaxable amounts.¹⁷ An organization's exemption is denied if its lobbying or grassroots expenditure normally exceed the applicable ceiling amount (i.e., are at least 150 percent of the nontaxable amount).

There is no rule preventing an organization that loses its exemption because it normally exceeds either of the section 501(h) ceilings from applying for restoration of the exemption in a subsequent taxable year. However, when an organization loses its exemption under section 501(c)(3) by reason of lobbying (either under the general substantiality test or through the application of section 501(h)), the organization cannot thereafter be treated as an exempt organization by reason of section 501(c)(4) (relating to civic organizations, social welfare leagues, etc.).¹⁸ The Treasury Department has regulatory authority to prescribe rules for preventing the evasion of this rule through the use of devices such as the transfer of an organization's assets to another organization.

3. Special rules for private foundations

In 1969, Congress enacted additional rules relating to political and lobbying expenditures by section 501(c)(3) organizations that are private foundations. Private foundations are defined under section 509 as all organizations described in section 501(c)(3) other than those expressly excepted, generally by reason either of being

¹⁷ Thus, in the above example, where the lobbying nontaxable amount was \$250,000, the lobbying ceiling amount is \$375,000. Since the grassroots nontaxable amount was \$62,500, the grassroots ceiling amount is \$93,750.

¹⁸ Section 504.

a specific type of organization, or of receiving broad-based financial support from the general public.

An organization is not treated as a private foundation, without regard to its sources of financial support, if it qualifies, under the applicable definitions, as one of the following: a church, an educational institution, a hospital or certain medical care or research organization, a foundation providing specified types of assistance to certain universities or colleges that are exempt from tax, or a governmental unit.¹⁹

In addition, an organization generally is not a private foundation if it normally receives a substantial part of its support from governmental units or direct or indirect contributions from the general public.²⁰ For this purpose, membership or attendance fees paid by members of the general public for services related to the organization's exempt function are treated as contributions.²¹

An organization that constitutes a private foundation is subject to a regulatory excise tax under section 4945 with respect to political and lobbying expenditures. The initial tax imposed equals 10 percent of the amount of such expenditures. In addition, each manager of the foundation who knowingly participates in the expenditure is taxed at a rate of 2.5 percent (up to a maximum of \$5,000).

If the expenditure is not corrected by the time that the Internal Revenue Service mails a deficiency notice with respect to the penalty tax (or such tax is assessed, if that occurs first), then additional penalty taxes are imposed. For the foundation, the additional tax equals 100 percent of the amount expended. For a manager who refuses to agree to corrective action, the additional tax is 50 percent of the amount expended (up to a maximum of \$10,000).

A final sanction may apply if the foundation continues not to correct its political or lobbying expenditures. Under section 507, willful repeated or willful and flagrant violations of the private foundation rules can lead to termination of private foundation status. The terminated organization can be required to pay to the Federal Government the value (with interest) of all tax benefits received (by the organization or charitable contributors thereto) by reason of the organization's former status under section 501(c)(3). This penalty tax may be abated to the extent that the organization contributes its assets to section 501(c)(3) organizations that are not private foundations.

4. Consequences of lobbying for tax treatment of donors

A final issue raised by lobbying activities of a section 501(c)(3) organization relates to the tax treatment of donors. In general, the fact that a section 501(c)(3) organization has engaged in lobbying, but only to an extent consistent with remaining exempt under the provision, has no effect on the charitable deductions of taxpayers

¹⁹ See sections 509(a)(1) and 170(b)(1)(a) (i) through (vi).

²⁰ Section 509(a)(2). However, such an organization may nonetheless be treated as a private foundation if two-thirds or more of the organization's support for a taxable year normally consists of unrelated business taxable income (net of the tax imposed on such income by section 511) or gross investment income.

²¹ An organization also may avoid treatment as a private foundation if it exists to support another section 501(c)(3) organization that is not a private foundation, subject to certain additional requirements relating to operation and control of such support organization. Section 509(a)(3).

making contributions to the organization. However, contributions to the organization that are specifically earmarked for lobbying are not allowable as charitable deductions.²²

When a taxpayer makes a contribution any part of which is deductible as a charitable contribution, no part of the contribution is deductible as a business expense.²³ Thus, a contribution that was partially earmarked for lobbying would not give rise to a business deduction with respect to the part not allowable as a charitable deduction. In the case of a contribution wholly earmarked for lobbying, other limitations on business deductions for lobbying would apply. In general, such expenses are deductible only if incurred in the course of a trade or business, with regard to a matter of direct interest to the taxpayer, and are not allowable with respect to grassroots lobbying.²⁴

B. OTHER TYPES OF EXEMPT ORGANIZATIONS

In general

A number of other organizations that are described in section 501(c), and that accordingly are exempt from tax, are subject to special rules to the extent that they engage in political or lobbying activities. The types of organizations most relevant in this regard are social welfare organizations (sec. 501(c)(4)), labor unions (along with agricultural and horticultural organizations) (sec. 501(c)(5)), trade associations (sec. 501(c)(6)), and veterans' organizations (sec. 501(c)(19)).

In general, these organizations are subject to less stringent restraints on conducting political and lobbying activities than are section 501(c)(3) organizations. These lesser restrictions reflect the fact that the above organizations—with the exception of veterans' organizations—are not benefited by the tax law to the same extent as section 501(c)(3) organizations.

The above organizations, like section 501(c)(3) organizations, generally are exempt from tax with respect to the performance of activities related to their exempt functions. However, in the case of social welfare organizations, labor unions, and trade associations, contributions made by taxpayers are not deductible as charitable contributions. (Membership contributions to such organizations may, however, be deductible as ordinary and necessary business expenses, except to the extent attributable to political activity or grassroots lobbying.)

By contrast, contributions to veterans' organizations, like contributions to section 501(c)(3) organizations, can give rise to charitable deductions. Thus, veterans' organizations benefit, in relation to section 501(c)(3) organizations, from more liberal standards regarding

²² See Treas. Reg. sec. 1.170A-1(h)(6). Since section 501(c)(3) organizations cannot engage in political activity, a contribution earmarked for political use likewise would not be allowable as a charitable deduction.

²³ See Section 162(b); Treas. Reg. sec. 1.162-15(a).

²⁴ Section 162(e). These rules are described more fully below, in B. "Other Types of Exempt Organizations."

political activity and lobbying, without being less favored by the tax law with respect to taxpayer contributions.²⁵

Social welfare organizations

Section 501(c)(4) provides a tax exemption for "[c]ivic leagues and organizations not organized for profit but operated exclusively for the promotion of social welfare." In addition, the provision applies to "local associations of employees * * * the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes."

Section 501(c)(4) organizations resemble section 501(c)(3) organizations in several respects. This resemblance results, not only from the parallel requirements of not being conducted for profit, but also from the similarity between promoting social welfare (section 501(c)(4)) and serving charitable purposes (section 501(c)(3)).

Two of the principal differences between the two provisions include, first, the fact that contributions to social welfare organizations are not deductible as charitable contributions, and, second, the fact that an organization is not disqualified under section 501(c)(4) by reason of being an "action organization" (i.e., one not qualifying under section 501(c)(3) by reason of its political or lobbying activities).

Social welfare organizations can qualify under section 501(c)(4) even if their activities consist in substantial part of political or lobbying activities. However, the exempt purpose of promoting social welfare does not include engaging in political activity (i.e., participating directly or indirectly in political campaigns on behalf of or in opposition to any candidate for public office).²⁶ This, if political activity is the organization's primary purpose, the organization is not exempt under section 501(c)(4), which requires that the promotion of social welfare be the organization's primary purpose.

Since political activity is defined as not a part of promoting social welfare, an organization whose primary purpose is political cannot be exempted under section 501(c)(4) even if its political activities bear some subject matter relationship to its social welfare goals. For example, assume that an organization seeks to promote environmental protection, and that this goal involves the promotion of social welfare. If the organization's primary means of pursuing this goal is supporting candidates for public office who support governmental programs to provide environmental protection, then the organization is not exempt under section 501(c)(4).

Different rules apply with regard to lobbying by social welfare organizations. Under appropriate factual circumstances, lobbying activities can be treated as relevant to the promotion of social welfare. Thus, an organization with social welfare goals can seek to advance those goals principally through lobbying, consistently with being exempt under section 501(c)(4). For example, if the organization described above sought to promote environmental protection principally by contacting Members of Congress to urge such Mem-

²⁵ In *Regan v. Taxation With Representation of Washington*, 461 U.S. 540 (1983), the Supreme Court held that it was not unconstitutional to permit veterans' organizations, consistent with retaining their exempt status, to engage in lobbying that would lead to denial of exemption if engaged in by a section 501(c)(3) organization.

²⁶ See Treas. Reg. sec. 1.501(c)(4)-2.

bers to vote in favor of environmental legislation, such organization still could qualify as exempt under section 501(c)(4).

Labor, agricultural, and horticultural organizations

Section 501(c)(5) provides a tax exemption for "[l]abor, agricultural, or horticultural organizations." Such an organization is not exempt, however, unless no net earnings inure to the benefit of any member, and the organization's aim is to improve the occupations to which it relates, with regard to working conditions, product quality, or general efficiency.²⁷ The provision exempts from tax organizations such as labor unions engaged in collective bargaining, and organizations that seek to improve the science of agriculture.

A section 501(c)(5) organization, like a social welfare organization, can engage in lobbying relating to its exempt purpose without endangering its exemption. The Internal Revenue Service has stated that political activities of section 501(c)(5) organizations are subject to the same limitation as such activities by social welfare organizations (i.e., such activities cannot be the primary means of accomplishing its exempt purposes).

Business leagues (trade associations)

Section 501(c)(6) provides a tax exemption for "[b]usiness leagues, chambers of commerce, real estate boards, boards of trade, or professional football leagues * * * not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual."

The exemption does not apply to organizations engaged in a regular business that ordinarily would be conducted for profit, or that provides information for the private benefit of individuals (e.g., furnishing investment advice). Rather, the exemption applies to organizations whose activities are directed to the improvement of business conditions in one or more lines of business.²⁸ The rules for political and lobbying activities by trade associations and other organizations exempt under section 501(c)(6) are the same as those for organizations exempt under paragraphs (4) and (5) of section 501(c).

Veterans' organizations

Section 501(c)(19) provides a tax exemption for veterans' organizations. In order for an organization to qualify for the exemption, at least 75 percent of its members must be past or present members of the United States Armed Forces, and substantially all other members must be cadets, or spouses, widowers, or widows of past or present members of the Armed Forces. Additionally, in order to qualify for exemption, none of the organization's net earnings can inure to the benefit of any private shareholders or individuals, and the organization must serve exempt purposes (such as benefiting the community or war veterans, or providing social or recreational activities for organization members).²⁹

Contributions to veterans' organizations, unlike contributions to organizations described under paragraphs (4), (5), or (6) of section

²⁷ Treas. Reg. sec. 1.501(c)(5)-1.

²⁸ Treas. Reg. sec. 1.501(c)(6)-1.

²⁹ Section 501(c)(19); Treas. Reg. sec. 1.501(c)(19)-1.

501(c), are deductible as charitable contributions.³⁰ The rules for political and lobbying activities by veterans' organizations are the same as those for organizations described under paragraphs (4), (5), or (6) of section 501(c).

C. TAX CONSEQUENCES (OTHER THAN LOSS OF EXEMPTION) OF POLITICAL AND LOBBYING ACTIVITIES BY EXEMPT ORGANIZATIONS NOT DESCRIBED IN SECTION 501(c)(3)

While political and lobbying activities by section 501(c) organizations (other than those exempt under section 501(c)(3)) are allowable to the extent described above, such activities may have tax consequences (other than denial of the exemption) under certain circumstances. Such tax consequences can relate either to a taxpayer claiming a business deduction for dues or other payments to such an organization, or to the organization itself.

As noted above, while contributions to a section 501(c) (4), (5), or (6) organization are not allowable as charitable deductions, such contributions may give rise to business deductions where all generally applicable requirements for such deductions are met.³¹ For example, the contribution must be an ordinary and necessary expense incurred in carrying on a trade or business (not, e.g., a personal expense that one elects to have one's business pay).³²

Among the requirements applying to business deductions generally, and thus to business deductions for contributions (such as dues) to section 501(c) (4), (5), or (6) organizations, is one relating to expenses for political and lobbying activity. In general, a taxpayer can deduct certain expenses of lobbying, in the course of a trade or business, with respect to legislation or proposed legislation that is of direct interest to the taxpayer.³³ No business deduction is allowed, however, either for political activity or for grassroots lobbying (i.e., attempting to influence the general public, or a part thereof, with respect to legislative matters, elections, or referendums).³⁴

Deductions for dues paid to organizations that engage in lobbying or political activities likewise are limited under these rules.³⁵ Longstanding regulations address the application of these rules in circumstances where a substantial part of the activities of an exempt organization consist of political activity or grassroots lobbying.³⁶ Under such circumstances, business deductions for dues or other payments to the organization are allowed only for such portion of the dues or other payments as the taxpayer can clearly establish are attributable to activities other than political activity or grassroots lobbying.³⁷

³⁰ Section 170(c)(3).

³¹ See Treas. Reg. sec. 1.162-15(c).

³² In practice, a contribution to a section 501(c)(4) organization may be less likely to give rise to a business deduction than a contribution, for example, to a labor union described by section 501(c)(5), or a trade association described by section 501(c)(6).

³³ Section 162(e)(1). The types of expenses that are deductible include expenses in connection with appearances before or other communications with committees or Members of Federal, State, and local legislative bodies, as well as expenses of communicating relevant information to members of organizations with direct interests in the legislation.

³⁴ Section 162(e)(2).

³⁵ Section 162(e)(1).

³⁶ Treas. Reg. sec. 1.162-20(c)(3).

³⁷ Id. The regulation also provides that lobbying expenses relating to matters of direct interest to the organization are treated, in effect, like lobbying expenses relating to matters of direct interest to the taxpayer.

The incurrence by a section 501(c) organization of expenses for political activities can have tax consequences even if the activities do not prevent the organization from qualifying as exempt under section 501(c). Specifically, tax liability can arise under section 527 (relating to political organizations), through the application of a rule designed to ensure that social welfare organizations will be treated similarly to political organizations with respect to political expenses.

Under section 527(f), an exempt organization is treated as having taxable income equal to whichever is the *lesser* of the following two amounts: its political expenditures³⁸ and its net investment income.³⁹ The amount so determined is subject to tax at the highest applicable corporate rate (34 percent for taxable years beginning after December 31, 1987). This provision promotes neutrality of treatment as between section 501(c) organizations that engage in political activities and section 527 political organizations because, as described in D, below, the latter organizations generally are taxed on net investment income.

As an example of this rule, assume that a section 501(c) organization has net investment income of \$100,000 and spends \$150,000 on political activities (i.e., exempt function expenditures for purposes of section 527). The income that is subject to tax at the highest corporate rate is \$100,000. If the organization had spent only \$80,000 on political activities, while still having net investment income of \$100,000, then the income subject to tax would have been \$80,000.

A section 501(c) organization can establish a separate segregated fund, receiving a separate allocable share of dues and keeping separate records, to engage in political activities. For purposes of section 527 (described more fully below), such fund is treated as a separate organization. Thus, the fund separately is subject to the general political organization rules of section 527, in lieu of taxing the organization as a whole under section 527.⁴⁰ The political activities of the fund are, however, relevant to determining whether the organization is exempt under section 501.

D. POLITICAL ORGANIZATIONS (SECTION 527)

In general, section 527 provides a tax exemption from Federal income tax for the income, other than investment income, of political organizations (e.g., political action committees). A political organization is defined as an organization that is organized and operated for the purpose of accepting contributions (directly or indirectly) or making expenditures, or both, for an exempt function.⁴¹ For this purpose, an "exempt function" is defined as "influencing or attempting to influence the selection, nomination, election, or ap-

³⁸ A political expenditure for this purpose is one that, if incurred by a section 527 political organization, would be treated as incurred for an exempt function, as defined by section 527(e)(2) (i.e., in "influencing or attempting to influence the selection, nomination, election, or appointment of any individual to any Federal, State, or local public office or office in a political organization * * *"). This definition may be broader than the definition of political activities generally applying for purposes of section 501(c).

³⁹ Net investment income is defined for this purpose as the excess of gross income from interest, dividends, rents, royalties, and net capital gains, over deductions directly connected with the production of such gross income.

⁴⁰ Section 527(f)(3).

⁴¹ Section 527(e)(1).

pointment of any individual to any Federal, State, or local public office or office in a political organization," including the election of Presidential or Vice Presidential electors.⁴²

While exempt from taxation for most Code purposes, political organizations are taxed, at the highest applicable corporate rate (34 percent for taxable years beginning after December 31, 1987), on political organization taxable income. Such income generally consists of gross income for the year, other than exempt function income, minus the deductions directly connected with the production of such gross income.⁴³ Exempt function income, which is not subject to tax, is income from sources such as contributions, membership dues, and political fundraising that is segregated for use in exempt functions (i.e., political activity).⁴⁴

Thus, for example, assume that in 1987 a political organization receives \$100,000 in political contributions and membership dues that it keeps segregated for appropriate political use. In addition, the organization earns \$20,000 in interest income (e.g., from depositing the political contributions in an interest-bearing checking account). The organization's political organization taxable income includes its interest income, but not the political contributions received, and accordingly equals \$20,000.

⁴² Section 527(e)(2).

⁴³ Section 527(c).

⁴⁴ Section 527(c)(3). Exempt function income can include proceeds from a political fundraising or entertainment event, sales of political campaign materials, or conducting a bingo game, if not received in the ordinary course of any trade or business.

VII. FINDINGS

Charitable and other tax-exempt organizations are an essential part of our society. Nonprofit organizations have promoted the social welfare, stimulated scientific and technological progress, cultivated educational, cultural and artistic endeavors, fostered religion, and provided a wealth of independent thought and innovative ideas. They continue to do so today with renewed vigor, in ever-increasing numbers.

The Internal Revenue Code contains the only Federal law provisions applying generally to the activity of all nonprofit organizations. Present law reflects a long-standing congressional judgment that the Federal benefits of tax-deductible contributions and exempt status generally should be denied in matters of political activities and substantial lobbying activities. That judgment is reaffirmed today. The Subcommittee finds that the prohibition against political activities and restrictions on legislative or other lobbying activities continue to represent sound tax policy.

The implementation of that policy, however, has given rise to a set of complex and at times inexact rules that are difficult to comply with and administer. The rules are complex because there are different rules for different types of organizations. The rules are sometimes inexact because of the imprecise definitions of lobbying and political activity. For example, it is often very difficult to distinguish lobbying or political activity from educational activity. Indeed, the timing of the release of a publication or a television broadcast or even subtleties of wording in an organization's publication can be key determining factors.

Even once an activity is determined to be a political activity or lobbying, other problems exist that can prevent the full, fair and complete administration of this long-standing tax policy. Such a concern was reaffirmed throughout the testimony presented at the Subcommittee on Oversight's hearings. Furthermore, the lack of clarity in the definition of terms makes compliance harder to achieve, the law easier to abuse without being detected, and enforcement of the law difficult to pursue.

The Subcommittee takes note of the special statutory regulation of one particular category of the section 501(c)(3) organizations: private foundations. The special rules were enacted in the Tax Reform Act of 1969 in light of findings that the general requirements for tax-exempt status, the specific rules governing a foundation's transactions and expenditures, and the revocation sanction, were ineffective to ensure that Federal income tax incentives would be available only where a foundation's assets and income are devoted to charitable, and not private, purposes. Accordingly, the 1969 Act developed additional rules and excise tax sanctions, including ones addressing lobbying and political activities. Greater public disclo-

sure is also required by private foundations than by other exempt organizations.

While the issues and concerns about the lobbying and political activities of tax-exempt organizations are much the same today as in the past, they are intensifying and can be expected to do so in the future. Even though many tax-exempt organizations comply with the restrictions, the opportunities for some exempt organizations to circumvent the law today are too numerous and the stakes far too high. The alarming use of tax-exempt organizations to further the political ambitions of a particular candidate demonstrates the need for clarification of current law and additional restrictions on this type of activity. Furthermore, the penalty that generally exists for violation of these rules and restrictions by a tax-exempt organization (i.e., revocation of an organization's tax-exempt status) is often inappropriate and ineffective and can have little deterrent effect. For those organizations deeply concerned about being in complete compliance of the law, the lack of clear guidelines coupled with the threat of the revocation sanction may inhibit many organizations from engaging in even permissible activities.

The Subcommittee finds that public disclosure of information and accountability by exempt organizations regarding lobbying and political activities as well as that regarding the tax-deductibility of contributions, is often deficient, misleading or even completely absent. The annual information return (Form 990) filed by exempt organizations with the Internal Revenue Service, which is available to the public, does not appear to be very useful. The Form 990 does not solicit the type of information on lobbying and political activities, particularly concerning the use of affiliated or multiple organizations, that would provide IRS with a valuable audit tool. Further, as a public document, the Form 990 does not provide timely clarification about what the organization is doing, where its funding comes from, or where it goes.

VIII. RECOMMENDATIONS

The Subcommittee on Oversight makes the following recommendations to the Committee on Ways and Means. In doing so, the Subcommittee Members express their interest in working with the Committee Members to more fully and appropriately develop the details, definitions, and procedural aspects of the Subcommittee's recommendations. The Subcommittee submits the following recommendations, on a bipartisan basis, as a conceptual starting point for legislation to improve the tax law applicable to lobbying and political activities of tax-exempt organizations.

I. PUBLIC DISCLOSURE

A. DISCLOSURE OF ELIGIBILITY TO RECEIVE TAX-DEDUCTIBLE CHARITABLE CONTRIBUTIONS

Recommendation

Exempt organizations should be required to state on public fundraising solicitations whether or not the organization is eligible to receive tax-deductible charitable contributions, and specify the organization's Federal tax status.

Such required statements should be made in conspicuous and easily recognizable format. The Subcommittee expects that any Treasury regulations or administrative rules developed by the Internal Revenue Service to implement such a requirement would be carefully prescribed so as to avoid any confusion or onerous burdens on organizations. Small exempt organizations, such as those organizations with gross receipts of less than \$100,000, may need to be excluded from such a requirement.

An appropriate penalty should be provided if an organization fails to provide such statements or which negligently or willfully provides false or misleading information. For example, the penalty could be \$10 for each solicitation with respect to which such failure occurs, not to exceed \$10,000 in any calendar year. Such a penalty should be waived upon a showing of reasonable cause.

Explanation

Under current law, charitable deductions for contributions to exempt organizations generally are allowed for Federal income tax purposes only for contributions to organizations organized and operated for charitable, educational, religious, etc. purposes (sec. 510(c)(3)); contributions to fraternal organizations (sec. 501(c)(10)) where such contributions are used exclusively for religious, charitable, scientific, etc. purposes; and contributions to certain veterans' organizations (sec. 501(c)(19)). Thus, contributions to other types of tax-exempt organizations are not deductible as charitable contributions. For example, contributions to a social welfare organization

(sec. 501(c)(4)) that engages in substantial lobbying activity are not deductible as charitable contributions.

Many different types of organizations soliciting "contributions" may not inform potential donors whether their contributions are tax-deductible and in some cases may suggest that contributions are deductible when in fact they are not deductible. The Subcommittee is concerned that many fundraising solicitations are either misleading or silent on the tax deductibility issue.

B. AVAILABILITY OF ANNUAL INFORMATION RETURNS TO THE PUBLIC

Recommendation

Exempt organizations should be required to make their applications for exemption (Form 1023 or Form 1024) and their annual information returns (Form 990) available to the public for inspection at the organization's offices upon request.

This requirement should be enforced through a penalty arrangement patterned after that applicable to private foundations. An organization would be penalized \$10 for each day during which a failure to allow public inspection continues, not to exceed \$5,000 in any calendar year, unless it is shown such failure is due to reasonable cause. Organizations could charge a reasonable fee for providing copies of the forms to the public.

Explanation

Present law provides that an organization's application for exemption and the annual information returns (except for donor lists) are disclosable to the public by the Internal Revenue Service. The Internal Revenue Service often does not, and at times cannot, make these documents available to the public in a timely manner.

Private foundations are required to file annual information returns (Form 990-PF). In addition, present law specifies generally that private foundations must make available a copy of the annual return, at the principal office during regular business hours of the foundation. The Subcommittee has determined that other exempt organizations, in addition to private foundations, should be held to higher standards of public disclosure and accountability. A good faith effort should be made by the organization to have all prior returns available. With regard to the availability for public inspection, if an organization does not keep the documents in all offices, then the organization's principal office should supply a copy of the document to the local office, which received the request, within a reasonable time.

II. ADDITIONAL REPORTING REQUIREMENTS OF SECTION 501(c)(3) ORGANIZATIONS

A. ON THE APPLICATION FOR RECOGNITION OF EXEMPTION

Recommendation

An organization seeking to be exempt under section 501(c)(3) should be required to state on its application for exemption whether the applicant organization: (a) was controlled by any other exempt organization within the last 5 years; (b) takes over the assets (including mailing lists and intangibles) of any other exempt

organization; or (c) had interlocking boards of directors with any other exempt organization within the last 5 years. The name, employer identification number, and tax status of any such affiliated or predecessor organization should be provided on the application for exemption.

Explanation

An organization, except a church, must file an application for exemption with the Internal Revenue Service and receive a favorable determination in order to have tax-exempt status under section 501(c)(3). This application form (Form 1023 or Form 1024) requests certain information, including the organization's purposes, funding, management and planned activities. However, the current form does not require information about past affiliated or predecessor organizations, including the employer identification numbers of such organizations. With such information, the Internal Revenue Service would be able to better audit the flow of funds and activities of section 501(c)(3) organizations who are the beneficiaries of tax-deductible contributions. This additional information would be particularly helpful to the Internal Revenue Service in instances where the prior affiliated organization's tax exemption has been revoked and the applicant organization has been established in its place.

B. ON THE ANNUAL INFORMATION RETURN (FORM 990)

Recommendation

Section 501(c)(3) organizations should be required to provide additional information on the Form 990 regarding affiliated organizations and the allocation of expenses and revenues. Such additional reporting would apply to those 501(c)(3) organizations which are now required to file annual information returns and which have gross receipts in excess of \$100,000. Such information should include the name, employer identification number and tax status of other exempt organizations with which the section 501(c)(3) organization: (a) has common or interlocking boards of directors, officers, etc.; or (b) shares salaried employees, office space, equipment or mailing lists, where such shared amounts total \$25,000 or more. In addition, required information should include the name, employer identification number and tax status of those exempt organizations to and from which funds or assets are transferred. Such requirements would not need to apply to affiliations or transfers between 501(c)(3) organizations.

This additional reporting requirement should be enforced through a penalty arrangement patterned after that applicable to private foundations. Thus, an initial penalty of \$10 for each day the failure to provide the information continues would be paid by the section 501(c)(3) organization, not to exceed \$5,000 in any calendar year. If the failure to report continues, beyond the time specified in the Internal Revenue Service's demand for the omitted information, then a penalty of \$10 for each day beyond that specified time would be assessed against the responsible person. Such penalty could be waived for reasonable cause and would not exceed \$5,000 in any calendar year.

The Committee may wish to extend this penalty to failure to provide any of the other information currently required on the Form 990.

Explanation

Present law requires that most exempt organizations, except churches, file an annual information return (Form 990) with the Internal Revenue Service. The current Form 990 does not require sufficient information about exempt organizations affiliated with, or closely connected to, section 501(c)(3) organizations with regard to the sharing of salaried employees, office space, mailing lists and other costs with exempt organizations, or the sale, lease, loan or transfer of funds and assets between exempt organizations. It is in these circumstances that particularly improper use of tax-deductible contributions can occur. More definitive information about the relationship of section 501(c)(3) organizations to other exempt organizations is needed by the Internal Revenue Service to better track the use of tax-deductible contributions and enforce current tax rules.

The Subcommittee recommendation reflects the special needs of small volunteer organizations by excluding section 501(c)(3) organizations with less than \$100,000 in gross receipts from the additional reporting requirements, and by excluding the reporting of a de minimis amount of shared expenses and costs.

III. RULES REGARDING THE POLITICAL ACTIVITIES OF SECTION 501(c)(3) EXEMPT ORGANIZATIONS

A. DEFINITION OF POLITICAL ACTIVITY

Recommendation

The current law definition of political activity should be clarified by expressly stating that political activity includes any attempt to affect the outcome of an election by promoting, endorsing or disapproving the candidacy of a particular individual.

Explanation

Current law prohibits section 501(c)(3) organizations from engaging in any political activity. Political activity is defined statutorily as to “* * * participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office”. Regulations interpret this language to include direct and indirect participation and/or intervention in a political campaign on behalf of or in opposition to any candidate for public office.

Particularly in light of the total ban on political activity by section 501(c)(3) organizations, the Subcommittee has concluded that greater specificity in the statutory definition of political activity is desirable. Such clarification would result in more effective guidelines for those organizations seeking to comply with the law. It would as well more clearly preclude the abusive situation of using tax-deductible contributions to oppose a candidate for public office. This recommendation, however, does not change current law. Thus, nonpartisan voter education projects, surveys, questionnaires,

forums for members, and other similar activities, will be unaffected by this clarification to the extent permitted under current law.

B. POLITICAL ACTIVITY VIOLATIONS

Recommendation (1)

The Internal Revenue Service should be given the authority to seek to enjoin the use of tax-deductible contributions by a section 501(c)(3) organization to finance continued egregious political (or other illegal) activity. Clear safeguards should be designed to ensure that the Internal Revenue Service exercises this authority only after approval by the Commissioner upon a showing of good cause, for only the most egregious of acts, and after the Service has given the organization notice of its intent to seek an injunction if the proscribed activity is not immediately ended. The courts should be given authority to enjoin such activity only upon a showing of clear and convincing evidence.

In addition, the Internal Revenue Service should be authorized to terminate the current taxable year of a section 501(c)(3) organization that is engaging in egregious political activity, to revoke the tax-exempt status of the organization, and to immediately assess and collect any taxes due. This termination authority is not to be used arbitrarily.

Explanation

The Internal Revenue Service currently does not have the authority to request a court injunction to prohibit illegal political activities of a section 501(c)(3) organization that are being paid for with tax-deductible contributions. As a result, a section 501(c)(3) organization may continue to act in violation of the law, while the Internal Revenue Service must wait for the filing of a tax return by the organization before commencing an examination. During this time, the 501(c)(3) organization may continue to solicit tax-deductible contributions.

This authority to bring an action in court to enjoin egregious political activity should be patterned after an action to enjoin income tax return preparers and an action to enjoin promoters of abusive tax shelters.

The availability of termination authority in this area would allow the Internal Revenue Service, in carefully prescribed circumstances, to impose a tax and applicable penalty on the organization for the year to date, or for the preceding tax year, where there has been egregious political activity. This authority would also allow the Service to revoke the tax-exempt status of the organization based on such political activity, without having to await the filing of the Form 990 for the tax year during which the activity occurs. This termination authority could be patterned generally after current termination procedures, with judicial review similar to that presently required for termination assessments.

Recommendation (2)

Section 501(c)(3) organizations that have their tax-exempt status revoked due to political activity should no longer be automatically reclassified as a section 501(c)(4) social welfare organization.

Explanation

Under present law, a section 501(c)(3) organization is automatically reclassified as a section 501(c)(4) exempt organization upon revocation of its 501(c)(3) status due to political activities. A section 501(c)(3) organization which loses its exemption on account of substantial lobbying, however, is prohibited from becoming a section 501(c)(4) organization. The Subcommittee believes that there is no justification for treating organizations that have violated the ban on political activities less strictly than those which have engaged in substantial lobbying.

Recommendation (3)

An excise tax should be imposed, in certain situations, on both a section 501(c)(3) organization and its responsible managers for engaging in political activity. The recommendation would provide a penalty in addition to revocation of tax-exempt status, and could be patterned after the private foundations taxable expenditure excise tax.

An initial tax equal to 25 percent of the political activity expenditure would be imposed on the organization, and a tax equal to 10 percent of the expenditure not to exceed \$5,000, would be imposed on an officer, director, trustee or manager who agrees to make the political expenditure knowing that it is prohibited. If the expenditure is not corrected within a specified period, an additional tax of 100 percent of the expenditure would be imposed on the organization, and 50 percent of the expenditure, not to exceed \$10,000, would be imposed on responsible persons who refused to agree to part or all of the correction.

Explanation

Present law does not impose penalties on 501(c)(3) organizations or responsible parties, except in the case of private foundations, for violations of the prohibition against political activity. The only sanction available to the Internal Revenue Service is revocation of the organization's tax exemption. The Internal Revenue Service often may be hesitant to revoke a section 501(c)(3) organization's tax-exempt status for political activity, particularly where the offending parties have left the organization, the violation was unintentional, or the situation has been otherwise cured. Furthermore, in the most egregious cases where a section 501(c)(3) organization was established and operated for the primary purpose of engaging in political activity, revocation is clearly ineffective as a penalty or as a deterrent.

The special rules governing private foundations have provided an effective and fair sanction in the form of excise taxes on both the foundation and its responsible managers for prohibited expenditures.

C. SECTION 501(C)(3) ORGANIZATIONS USED TO BENEFIT POLITICAL CANDIDATES

Recommendation

The present law definition of political activity should be extended to include instances where a section 501(c)(3) organization is

used for the primary benefit of a candidate for elective public office. Expenditures by a 501(c)(3) organization in payment of honoraria, travel, advertising and publicity, research and issue preparation, and mailing and fundraising preparation should be considered political activity if, in a taxable year, more than one-half of the total of such expenditures incurred in connection with, or accrued to the benefit of, a candidate for elective public office. Also, such expenditures would be considered political activity if made in connection with a candidate in the year immediately preceding that candidate's declaration of a candidacy or formation of an exploratory committee.

The organization and responsible trustees, officers, directors, and managers engaged in this political activity should be subject to the excise taxes for political activity set forth in the prior recommendation.

The Subcommittee suggests that the Committee may wish to consider the following additional or alternative options as well:

(a) Prohibit any expenditures by section 501(c)(3) organizations for payments of honoraria, travel, advertisements, any research and issue preparation, and mailings and fundraising preparation, which benefit a single candidate or particular slate of candidates.

(b) Prohibit the loan, rental, or sale by a section 501(c)(3) organization of its mailing lists to a candidate for campaign fund solicitations.

(c) Impose excise tax penalties directly on the candidate where the candidate encouraged the prohibited expenditure and knowingly accepted it.

Explanation

Numerous tax-exempt organizations have been established in recent years to promote, directly or indirectly, the candidacy or public recognition of individuals seeking, or currently holding, elective public office. A section 501(c)(3) organization is often established to promote a specific individual through activities such as seminars, dinners, and conferences where the political figure is the principal or even the only speaker; through research which is conducted and funded by the organization for the ultimate use by the individual; and other activities targeted to benefit the political figure for whom the organization was created and operated. Tax-deductible contributions may be financing political activities. The increasing use of tax-exempt organizations to benefit a political candidate for public office runs counter to Federal tax concerns and allows for the circumvention of the contribution and spending restrictions contained in the Federal Election Campaign Act.

D. COORDINATION BETWEEN THE INTERNAL REVENUE SERVICE AND THE FEDERAL ELECTION COMMISSION

Recommendation

The Internal Revenue Service and the Federal Election Commission should be encouraged to cooperate in accordance with their statutory mandates. The Federal Election Commission should be encouraged to provide the Internal Revenue Service, on a routine

basis, with information regarding the campaign activities of organizations which the Federal Election Commission knows are tax-exempt under section 501(c)(3), including known violations of the Federal election campaign law, advisory opinion requests, and reallocation of expenditure determinations.

Explanation

The Internal Revenue Service is not routinely notified or aware of the Federal Election Campaign Act enforcement efforts by the Federal Election Commission involving exempt organizations. Greater coordination between these two agencies would help ensure that exempt organizations are not used for prohibited political purposes.

IV. NEW RULES RELATING TO LOBBYING ACTIVITIES OF EXEMPT ORGANIZATIONS

A. DEPARTMENT OF THE TREASURY STUDY

Recommendation

The Subcommittee recommends that the Department of the Treasury and the Internal Revenue Service study and report to the Subcommittee concerning the appropriateness and feasibility of a single definition of lobbying activities for all section 501(c)(3) organizations.

Explanation

In general, section 501(c)(3) organizations can engage in insubstantial amounts of lobbying activities. The determination which constitutes permissible insubstantial lobbying is based on all the facts and circumstances surrounding the case. Alternatively, a public charity generally may elect under section 501(h) to have the amount of permissible lobbying measured under an objective mathematical expenditures test, rather than just the general "substantiality" standard. The Internal Revenue Service currently is reviewing comments received on the proposed regulations pertaining to the expenditures test. The intense controversy that has arisen over these proposed regulations, and the lack of clarity in the lobbying definitions set forth in the Code, clearly demonstrate the need for review of the desirability of a single rule governing lobbying activities.

B. LOBBYING ACTIVITY VIOLATIONS

Recommendation

An excise tax should be imposed, in certain circumstances, on both a section 501(c)(3) organization and its responsible managers for engaging in substantial lobbying activity. The recommendation would provide a penalty in addition to revocation of tax-exempt status, and could be patterned after the private foundation taxable expenditure excise tax.

An excise tax would be imposed in instances where the organization has had its exempt status revoked due to substantial lobbying activities. The tax in the amount of 5 percent of the total lobbying expenditures incurred in the year(s) on which the revocation is

based would be imposed on the organization as well as an officer, director, trustee or manager who knowingly or willfully agreed to the substantial lobbying expenditures.

Explanation

Under present law, a section 501(c)(3) organization which has exceeded the elected section 501(h) expenditure amount is subject to an excise tax and ultimately may have its exempt status revoked.

The only sanction currently available to the Internal Revenue Service, where a non-electing section 501(c)(3) organization has engaged in substantial lobbying, is revocation of exempt status. Further, in the most abusive situations, the revocation sanction may not be an appropriate penalty or deterrent. As described earlier, present law imposes excise taxes on both private foundations and their managers for prohibited expenditures, including prohibited lobbying expenditures.

V. ADMINISTRATION OF THE LAW BY THE INTERNAL REVENUE
SERVICE

Recommendation

The Internal Revenue Service should be encouraged to establish and implement a specific examination program for lobbying and political activities of exempt organizations. The Internal Revenue Service should report annually to the tax-writing committees of the Congress on Service activities in this area.

Explanation

The Internal Revenue Service does not have a specific program for examining exempt organizations' compliance with the lobbying and political activity rules.

APPENDIXES

A. LIST OF WITNESSES TESTIFYING

THURSDAY, MARCH 12, 1987—BEGINNING AT 9:00 A.M.—ROOM 1100, LONGWORTH HOUSE
OFFICE BUILDING

Panel:

Bruce Hopkins: Baker and Hostetler
Jennie S. Stathis: Associate Director, General Government Division, United
States General Accounting Office

Panel:

The Honorable Roger Mentz: Assistant Secretary for Tax Policy, Department of
Treasury
The Honorable Lawrence B. Gibbs, Jr.: Commissioner, Internal Revenue Service
The Honorable Scott E. Thomas: Chairman, Federal Election Commission; Ac-
companied by: The Honorable Thomas J. Josefiak, Vice Chairman, and
Charles N. Steele, General Counsel

Panel:

John Jones, Jr.: Chair, Section of Taxation, American Bar Association
William J. Lehrfeld: Lehrfeld and Henzke, P.C.
Leonard L. Silverstein: Silverstein and Mullens

Panel:

Brian O'Connell: President, Independent Sector
Thomas Troyer: Counsel, Caplin and Drysdale; on behalf of Independent Sector
Harold Freeman: Member, National Board of Directors, American Cancer
Society
Michael Hudson: Attorney-at-Law, Austin, Texas
Jack Moskowitz: Senior Vice President, Government Relations, United Way of
America

Panel:

Norma Phillips: Vice President, Mothers Against Drunk Driving
Betty Williams: Director of Public Affairs for the Indiana Planned Parenthood
Affiliates Association; on behalf of the Indianapolis Coalition for Human
Services
Alan P. Dye: Counsel to the Council on Non-Profit Organizations, Inc.
John W. Johnson: Executive Vice President, American Collectors Association,
and Chairman of the Board, American Society of Association Executives

FRIDAY, MARCH 13, 1987—BEGINNING AT 9:00 A.M.—ROOM 2322, RAYBURN HOUSE OFFICE
BUILDING

Sheldon Cohen: Morgan, Lewis and Bockius

Panel:

John Buchanan: Chairman, People For the American Way
Edwin J. Feulner, Jr., Ph.D: President, the Heritage Foundation

Panel:

Jackie A. Strange: Vice President and Chief Executive Officer, The Dole Foun-
dation for the Employment of Persons with Disabilities; Accompanied by:
Jeanne Argoff, Grants Program Manager
Martha Keys: Executive Director, Center for a New Democracy
John R. Wallace: Counsel, North Carolina Democratic Party

Panel:

Paul S. Egan: Deputy Director, National Legislative Commission, The American Legion

John F. Heilman: National Legislative Director, Disabled American Veterans

James N. Magill: Director, National Legislative Service, Veterans of Foreign Wars of the United States

Panel:

Robert Bothwell: Executive Director, National Committee for Responsible Philanthropy

Joseph W. Blackburn: Counsel, Coalition of Health Care Organizations, Birmingham, Alabama

James Lescault: Executive Director, Urban Educational Systems, Inc., Jamaica Plain, Massachusetts

B. STATISTICAL INFORMATION

This appendix contains statistical information developed by the General Accounting Office through analysis of Internal Revenue Service data.

TABLE 1.—NUMBER OF TAX-EXEMPT ORGANIZATIONS IN CATEGORIES MOST LIKELY TO ENGAGE IN LOBBYING AND/OR POLITICAL ACTIVITIES AS OF OCTOBER 31, 1986 ¹

Organization category	Type of tax-exempt organization	Number of organizations	Percent of total
Section 501(c)(3) ²	Entities organized and operated exclusively for religious, charitable, scientific, testing for public safety, literacy, or educational purposes, or for the prevention of cruelty to children or animals or to foster amateur sports.	^a 371,395	44
Section 501(c)(4)	Civic leagues or organizations operated exclusively for the promotion of social welfare and local associations of employees devoted to charitable, educational, or recreational purposes.	126,664	15
Section 501(c)(5)	Labor, agricultural, or horticultural organizations operated to provide education or instruction on improving working conditions and products.	71,679	9
Section 501(c)(6)	Business leagues, chambers of commerce, real estate boards, professional football leagues, etc., established to improve business conditions.	54,654	6
Section 501(c)(19)	Past or organization established to promote the welfare of past or present members of the Armed Forces.	24,310	3
Section 527	Political organizations established to accept contributions and make expenditures for a political candidate.		
All other 501(c) organizations		193,264	23
Total 501(c) organizations		841,966	100

¹ IRS does not have statistics on the number of section 527 political organizations.

² Excludes religious organizations which did not apply for tax-exempt status.

^a According to an IRS program official, this figure includes about 37,000 private foundations.

Source: IRS exempt organization/business master file.

TABLE 2.—TYPE OF LOBBYING AND/OR POLITICAL ACTIVITY INDICATED BY ORGANIZATIONS ON THEIR APPLICATION FOR TAX-EXEMPT STATUS ¹

Activity	Number of reporting organizations
Propose, support, or oppose legislation	6,119
Voter information on issues or candidates	385
Voter education on registering and voting	1,384
Support, oppose, or rate political candidates	25
Provide facilities or services for political campaign activities	4
Other lobbying and political activities	239

¹ Some organizations may have reported plans to engage in more than one of the above activities.

Source: IRS exempt organizations/business master files as of June 30, 1986.

TABLE 3.—THE NUMBER OF EXEMPT ORGANIZATIONS REPORTING PRIMARY ACTIVITY OF A LEGISLATIVE OR POLITICAL NATURE

Activity	Number and type of exempt organization					Total
	Section 501(c)(3)	Section 501(c)(4)	Section 501(c)(5)	Section 501(c)(6)	Other	
Propose, support, or oppose legislation	33	947	725	194	35	1,934
Voter information on issues or candidates	43	108	2	3	0	156
Voter education on registering and voting	40	451	3	1	2	497
Support, oppose, or rate political candidates	0	1	0	0	0	1
Provide facilities or services for political campaign activities	0	1	0	0	1	2
Other legislative and political activities	28	26	1	7	5	67
Total	144	1,534	731	205	43	2,657

Source: IRS exempt organizations/business master file as of Apr. 27, 1986.

TABLE 4.—POLITICAL ACTIVITIES OF ORGANIZATIONS SURVEYED DURING THE IRS' 1986 TAXPAYER COMPLIANCE MEASUREMENT PROGRAM ¹

	Number and type of organization							Total
	Section 501(c)(3) private	Section 501(c)(3) public	Section 501(c)(4)	Section 501(c)(5)	Section 501(c)(6)	Section 501(c)(7)	Section 501(c)(8)	
Total TCMP sample	2,307	3,240	2,072	2,613	2,623	2,585	2,062	17,502
Political activity reported:								
Non-exempt political activities ²	1	2	2	153	22	1	1	182
Expended funds for political purposes	3	5	8	286	99	2	3	406
Maintained a separate segregated fund	1	2	7	180	158	0	0	348
Participated or intervened in a political campaign ³	4							4

¹ Some organizations may be reported as engaging in more than one of the listed activities.² An IRS official defined nonexempt political activity as political activity not germane to the organization's exempt purpose.³ Number reported on form 990-PF—Return of Private Foundation.

Source: IRS 1986 Taxpayer Compliance Measurement Program Survey.

C. STATEMENT OF J. ROGER MENTZ, ASSISTANT SECRETARY (TAX POLICY),
DEPARTMENT OF THE TREASURY

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to review with the Subcommittee the Federal tax rules applicable to lobbying and political activities of tax exempt organizations.

I will give a brief summary of present law and will discuss the rationale for the current restrictions on lobbying and political activities by certain exempt organizations. I will offer several recommendations that you may wish to consider to improve the operation of the law in this area. The Honorable Lawrence B. Gibbs, Commissioner of Internal Revenue, will describe the Internal Revenue Service's examination program and its experience in administering present law. Although other laws also apply to lobbying and political activities by exempt organizations, such as the Federal Election Campaign Act, we will not be addressing those laws except by occasional reference.

BACKGROUND

Section 501(c) of the Internal Revenue Code of 1986 (the "Code") describes twenty-five types of organizations that are generally exempt from federal income tax (except to the extent of their unrelated business taxable income described in section 512). Contributions to some of these organizations are deductible for federal income, estate, and gift tax purposes. Tax exempt organizations are subject to a variety of direct and indirect restrictions on lobbying and political activities. Different restrictions apply depending upon whether a particular activity is considered lobbying or a political activity and upon the type of organization engaging in the activity. Religious, charitable and educational organizations, which are exempt under section 501(c)(3) of the Code and are eligible to receive tax

deductible charitable contributions, are subject to the most stringent restrictions.

Lobbying Activities

Section 501(c)(3) Organizations (other than Private Foundations)

In General. Section 501(c)(3) of the Code provides tax exempt status for religious, charitable, educational and certain other categories of organizations. These organizations (other than private foundations which are also exempt under section 501(c)(3)) are often referred to as "public charities". Contributions to these organizations are generally deductible for federal income, estate, and gift tax purposes. In order to be recognized as tax exempt under section 501(c)(3), the organization claiming the exemption is required to file an application with the Internal Revenue Service (the "Service"). If an organization satisfies the requirements of section 501(c)(3), the Service issues a ruling or determination letter to the organization, recognizing its exempt status. In order to assist contributors, the Service periodically publishes a list of exempt organizations that are entitled to receive tax deductible contributions. If an organization is on the current list, contributions to the organization will in most instances be deductible even if, at a later date, the organization loses its exempt status. Organizations seeking tax exempt status under provisions of the tax law other than section 501(c)(3) usually seek a ruling from the Service, but are not required to do so.

Since 1934, the law has provided that otherwise qualifying organizations are not exempt under section 501(c)(3) unless "no substantial part of the activities of [the organization] is carrying on propaganda or otherwise attempting to influence legislation". If an organization is recognized as exempt under section 501(c)(3) and subsequently engages in substantial lobbying activities, its exempt status will be revoked, effective as of the date it first engaged in substantial lobbying.

Definition of Lobbying. Under existing Treasury regulations, an organization is regarded as attempting to influence legislation if it: "(a) contacts, or urges the public to contact, members of a legislative body for the purpose of proposing, supporting or opposing legislation or (b) advocates the adoption or rejection of legislation." "Legislation" includes action by Congress by any State legislature, by local governing bodies, or by the public in a referendum, initiative, constitutional amendment or similar procedure. It is not relevant whether the lobbying activity will help further an exempt purpose of the organization.

Not every activity that could have a bearing on legislation

is viewed as lobbying. Under certain circumstances, study, research and discussion of matters pertaining to public affairs, and even to specific legislation, may be treated as educational activities rather than as attempts to influence legislation. For example, the Service has ruled that an organization established to study, research, and assemble materials on prospective court reform legislation and to distribute such material to the public was engaged in an educational activity and thus qualified for exemption under section 501(c)(3). Rev. Rul. 64-195, 1964-2 C.B. 138. In addition, the Service has ruled that an organization conducting research and discussions regarding the problems of a metropolitan area, but not specifically proposing legislation, is exempt from tax under section 501(c)(3) even though some of the policies formulated by the organization could only be carried out by legislative action. Rev. Rul. 70-79, 1970-1 C.B. 127. Finally, the Service has ruled that an educational institution is not engaged in prohibited legislative activity if, at the request of a legislative committee, a representative testifies on pending legislation. Rev. Rul. 70-449, 1970-2 C.B. 111. As illustrated by these rulings, there is no bright line distinguishing between "lobbying" and a permissible activity such as an "educational" discussion of social policy.

Substantial Part Test. The meaning of the term "no substantial part" as used in section 501(c)(3) to limit lobbying activity has been the subject of considerable debate since the enactment of the provision in 1934. In Seasongood v. Commissioner, 227 F.2d 907 (6th Cir. 1955), the Sixth Circuit Court of Appeals held that where an organization devoted less than five percent of its time and efforts for legislative activities, such activities were not substantial. However, in Christian Echoes National Ministry, Inc. v. United States, 470 F.2d 849 (10th Cir. 1972), cert. denied, 414 U.S. 864 (holding that a church failed to qualify for section 501(c)(3) status because of substantial lobbying and political activity), the Tenth Circuit Court of Appeals found that "a percentage test to determine whether the activities were substantial obscures the complexity of balancing the organization's activities in relation to its objectives and circumstances." *Id.* at 855. In Haswell v. United States, 500 F.2d 1133 (Ct. Cl. 1974), cert. denied, 419 U.S. 1107 (1975), the Court of Claims used both a percentage of expenditures test and an examination of whether legislation was one of the primary purposes of the organization to hold that the organization in question engaged in substantial legislative activity. (The organization in Haswell was organized to promote rail passenger services, operations and facilities; its legislative expenditures during the years in question ranged from 16.6 percent to 20.5 percent of its total budget.)

Elective Expenditure Test. In 1976, Congress was concerned that the "substantial part" test was so vague and uncertain that charitable organizations were unable to determine the limits of permissible lobbying activity. In addition, some believed that the vagueness of the substantial part test could encourage

subjective and selective enforcement.

In response to these concerns, Congress enacted Code sections 501(h) and 4911. Under these provisions, a section 501(c)(3) organization (with certain exceptions, including churches and private foundations) may elect to be subject to a mechanical test, based on expenditures, for determining a permissible level of lobbying. The permissible level of lobbying (the "lobbying nontaxable amount") is based on a sliding scale, ranging from 20 percent of the first \$500,000 of exempt purpose expenditures (i.e., charitable, educational, etc. expenditures) down to 5 percent of exempt purpose expenditures in excess of \$1,500,000, with a cap on the lobbying nontaxable amount of \$1,000,000. "Grass roots" lobbying (the "grass roots nontaxable amount") may not constitute more than 25 percent of the total lobbying nontaxable amount.

In order to prevent organizations from using a group of affiliated organizations to avoid the effect of the sliding scale of limitations, section 4911 generally treats the members of an affiliated group as one organization for purposes of computing the expenditure limitations. For purposes of section 4911, two organizations are treated as affiliated if (1) the governing instrument of one organization requires it to be bound by decisions of the other organization on legislative matters, or (2) the governing board of one organization includes persons who are designated members (or are key persons) of another organization and such persons have sufficient voting power to prevent legislative action by the first such organization.

For purposes of this expenditure test, section 4911(d) of the Code broadly defines lobbying as any attempt to influence any legislation through: (1) an attempt to affect the opinions of the general public or any segment thereof ("grass roots" lobbying); or, (2) through communication with any members or employees of a legislative body, or with any government official or employee who may participate in the formulation of the legislation ("direct lobbying"). The statute expressly excludes the following from the definition of lobbying: (1) making available the results of nonpartisan analysis, study or research; (2) providing technical advice or assistance in response to a written request from a governmental body or committee or other subdivision; (3) appearances before, or communications to, any legislative body with respect to a possible decision of such body which might affect the existence of the organization, its powers and duties, tax-exempt status, or the deduction of contributions to the organization; (4) communications between the organization and its bona fide members with respect to legislation or proposed legislation of direct interest to the organization and such members if the communications do not directly encourage lobbying or grass roots lobbying; and (5) communications with government officials other than members or employees of a legislative body, (e.g., officials in the executive branch), unless the principal purpose of the communication is to influence legislation.

An organization that elects the expenditure test is subject to a 25 percent excise tax on any lobbying expenditures in excess of the lobbying nontaxable amount or, if greater, any grass roots lobbying expenditures in excess of the grass roots nontaxable amount. An electing organization's exempt status is revoked if it "normally" (that is, on average over a four year period) makes lobbying expenditures in excess of 150 percent of the lobbying nontaxable amount or grass roots expenditures in excess of 150 percent of the grass roots nontaxable amount.

On November 5, 1986, the Treasury Department published proposed regulations under section 501(h), section 4911, and related sections. In general, these proposed regulations would further define lobbying and provide rules for determining what expenditures are treated as lobbying expenditures. The proposed regulations deal with a number of difficult issues and are currently the subject of vigorous public debate. The public comment period terminates on April 3, 1987, and a public hearing has been scheduled for May 11, 1987.

Prohibition Against Becoming A Social Welfare Organization.
An organization that cannot qualify for exempt status under section 501(c)(3) because it intends to engage in substantial lobbying activities may qualify as a social welfare organization under section 501(c)(4). A social welfare organization, contributions to which are not deductible for federal income, estate, and gift tax purposes, is defined as an organization primarily engaged in promoting the common good and general welfare of the people of the community.

In 1976, in addition to being concerned about the vagueness of the "substantial part" test, Congress was concerned that a section 501(c)(3) organization could establish a large endowment through deductible contributions and, if it lost its section 501(c)(3) status because of excessive lobbying, could then qualify as a social welfare organization under section 501(c)(4). Although it would no longer be entitled to receive tax deductible contributions, the income on its endowment would remain exempt. To prevent this abuse of section 501(c)(3) status, Congress enacted section 504 of the Code which prohibits an organization that has lost its section 501(c)(3) status because of excessive lobbying from qualifying for tax exempt status as a section 501(c)(4) organization. Section 504 was intended to ensure that such an organization would be subject to tax until such time as it could regain its section 501(c)(3) status through reapplication to the Service. The Treasury Department is specifically granted regulatory authority to prevent avoidance of section 504, including the authority to promulgate regulations

¹ Proposed regulations have no legal authority until they are published in final form.

dealing with direct and indirect transfers among commonly controlled organizations. The regulations proposed by Treasury on November 8, 1986, noted above, also contain rules under this provision.

Affiliated Organizations. A section 501(c)(3) organization that desires to engage in substantial lobbying may establish a separate section 501(c)(4) organization. Typically, the section 501(c)(3) organization, which is entitled to receive tax deductible contributions, carries on research and educational activities while the section 501(c)(4) organization carries on lobbying activities. Such an arrangement is permissible under present law so long as separate books are kept and expenses are properly allocated between the two organizations.

Under section 482 of the Code, the Service has the authority to reallocate expenses between exempt organizations under common control in order to reflect accurately the substance of their dealings. For example, if a section 501(c)(3) organization conducts research and prepares an extensive report for the use of a lobbying effort carried on by a section 501(c)(4) organization, at least part of the cost of the research and the report should be allocated to the section 501(c)(4) organization. If the organizations have not properly allocated expenses, the misallocation of expenses could be viewed as a contribution by the section 501(c)(3) organization to the section 501(c)(4) organization in order to carry on lobbying activities, thus subjecting the section 501(c)(3) organization to loss of its exempt status if the activity is substantial. Alternatively, the misallocation of expenses could be viewed as a loan to the section 501(c)(4) organization, in which case repayment of the loan could be required. Cf. Rev. Proc. 65-17, 1965-1 C.B. 833.

Private Foundations

In general, private foundations are organizations described in section 501(c)(3) (with certain exceptions including churches, hospitals and educational institutions) that are primarily supported by a small number of contributors and do not receive substantial support from the general public. Private foundations are subject to more stringent rules with respect to lobbying activities than are other section 501(c)(3) organizations.

Since 1969, all lobbying expenditures by a private foundation have constituted "taxable expenditures" under section 4945 and, as such, are subject to a two-tier excise tax. The first tier consists of a tax equal to 10 percent of the amount of the expenditure, levied on the foundation, and a 2 1/2 percent tax (with a cap of \$5,000) levied on the management of the foundation if it knew that the expenditure was a taxable expenditure. In any case in which the first tier tax is levied on the foundation, and the expenditure is not "corrected" in a timely manner, a second tier tax is imposed on the foundation equal to 100 percent

of the amount of the expenditure. If the management of the foundation fails to implement the required correction, a tax equal to 50 percent of the expenditure is imposed on the management (with a cap of \$10,000). Treasury regulations provide that correction of an expenditure means recovery of the expenditure to the extent possible. Where full recovery is impossible, the Commissioner may prescribe other corrective action including requiring that no further grants to the particular grantee be made, that the foundation make additional reports to the Service, and that improved expenditure procedures be implemented by the foundation.

Section 4945 contains a definition of lobbying that is similar to that in section 4911, discussed above.

If a private foundation incurs excise tax liability as a result of engaging in either willful repeated acts, or a willful and flagrant act (or failures to act), its private foundation status may be terminated and it may be subject to a termination tax. Generally, the phrase "willful repeated acts or failures to act" means at least two voluntary, conscious or intentional acts or failures to act. The termination tax is the lower of the aggregate tax benefit resulting from the private foundation's section 501(c)(3) status or the value of the net assets of the foundation. The Service may abate all or a portion of the termination tax if the private foundation transfers all of its assets to one or more public charities which have been in existence for a continuous period of 60 months or more or if the private foundation gives effective assurance to the Service that its assets will be used for charitable purposes.

Other Exempt Organizations

No direct limitations are placed on the lobbying activities of exempt organizations other than those described in section 501(c)(3). Social welfare organizations, labor unions, trade associations and veterans' organizations may, and often do, engage in extensive lobbying.

An organization is exempt under section 501(c)(4) as a social welfare organization if it is primarily engaged in promoting the common good and general welfare of the community. A social welfare organization may engage in substantial lobbying as long as it is related to its exempt purpose. Further, an organization may be exempt as a social welfare organization if its primary objective may be attained only by the passage or defeat or legislation, and it advocates or campaigns for such legislation. As noted above, however, contributions to social welfare organizations are not deductible.

Similarly, there is no direct limitation on lobbying activities of labor unions (which are exempt under section 501(c)(5)) and trade associations (which are exempt under section

501(c)(6)). Lobbying activities of these organizations, however, may have tax consequences to their members. Section 162(e)(1) provides that ordinary and necessary business deductions include expenses paid or incurred for certain direct communications with legislators, and communications between organizations and their members, concerning legislation of direct interest to the taxpayer. Section 162(e)(2)(B), however, prohibits the deduction of expenses for grass roots lobbying. Existing Treasury regulations provide that if a substantial part of the activities of an exempt organization such as a labor union or a trade association consists of lobbying, other than certain permitted communications with legislators and members, a deduction is allowed only for that portion of the dues that the taxpayer can clearly establish is attributable to non-lobbying (or to permissible lobbying) activities of the organization. Thus, for example, if a company pays \$200 dues to a trade association, and one-half of the trade association's activities consist of grass roots or other impermissible lobbying, then only one-half of the dues, or \$100, will be deductible.

Finally, no direct limitation is placed on the lobbying activities of veterans' organizations which are exempt under section 501(c)(19). These organizations, however, qualify for tax deductible contributions.

Political Activities

The restrictions on political activities of tax exempt organizations are somewhat different than the restrictions that apply to legislative or lobbying activities.

Section 501(c)(3) Organizations (Other Than Private Foundations)

An organization cannot qualify for tax exemption under section 501(c)(3) if it "participate[s] in, or intervene[s] in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office." Treasury regulations provide that participation in a campaign includes, but is not limited to, spoken or written statements on behalf of or in opposition to a candidate.

Some activities that involve political campaigns are, nevertheless, permitted by this provision, either because they are viewed as nonpartisan and thus educational or because the activity is not attributed to the organization. Certain voter education activities, if carried on in a nonpartisan manner, do not constitute intervention in a political campaign. For example, the Service ruled that an organization that prepared and made available to the public an annual compilation of the voting records of all members of Congress on major legislative issues

was exempt under section 501(c)(3). Rev. Rul. 78-248, 1978-1 C.B. 154. The Service has also held that if an exempt educational institution offers a political science course that requires involvement of the students in a political campaign of their choice, or if the institution supports a student newspaper that expresses editorial opinions on elections, the institution itself is not involved in prohibited political activity. Rev. Rul. 72-512, 1972-2 C.B. 246; Rev. Rul. 72-513, 1972-2 C.B. 246.

Private Foundations

The restrictions on political activities of private foundations are similar to the restrictions on lobbying activities of private foundations. Since 1969, any amount paid or incurred by a private foundation to influence the outcome of any public election, or to carry on, directly or indirectly, any voter registration drive (except as provided in section 4945(f)) has been treated as a taxable expenditure. A voter registration drive is permitted if it is nonpartisan, if it is carried on in five or more states, if the organization running the drive meets certain expenditure and support tests, and if contributions for the drive are not earmarked for specified states (or political subdivisions) or for a specific election period. The private foundation sanctions for political expenditures are the same as for lobbying expenditures -- i.e., a two-tier tax on the foundation and its management, with the correction of any prohibited expenditure required in order to avoid the second tier tax. Termination of private foundation status and imposition of a termination tax, as described above, is also a possible sanction.

Other Exempt Organizations

There is no direct limitation on participation in political activities by exempt organizations other than those described in section 501(c)(3). However, an organization would not satisfy the definition of any of the 25 organizations described in section 501(c) and, thus, would not qualify as exempt if its primary activities involved participation in political campaigns. Treasury regulations expressly provide that the promotion of social welfare does not include political campaign activity. In addition, as explained below, any section 501(c) organization that engages in political activities is subject to tax on its investment income to the extent of its political expenditures.

As is the case with lobbying activities by exempt organizations such as labor unions or trade associations, participation in political activities by such organizations cause a portion of the dues paid by the members to be nondeductible (if the combined lobbying and political activity is substantial).

Political Organizations

Section 527 of the Code governs the taxation of political organizations. A political organization is, in general, any organization created and operated primarily for accepting contributions and making expenditures for the purpose of influencing the election or appointment of an individual to a public office or office in a political organization. A political organization is exempt from taxation on its income from contributions, dues, fundraising events and bingo, but is subject to tax on its other income such as investment income. The tax rate is the maximum corporate rate, unless the organization is a principal campaign committee of a Congressional candidate, in which case the graduated corporate rates apply. Contributions to a political organization are not deductible for federal income, gift, and estate tax purposes. In addition, they are not subject to gift tax.

If an organization described in section 501(c) engages in political activity, the organization is subject to tax under section 527 on the lesser of the amount of political expenditures or the organization's net investment income. A section 501(c) organization may maintain a segregated fund for political activities in which case the segregated fund is treated under section 527 as a separate political organization. Contributions to a segregated fund are not deductible. The legislative history of section 527 indicates the provisions were not intended to affect in any way the prohibition against participation in political activities by section 501(c)(3) organizations or the tax on private foundations that engage in political activities. Thus, establishment of a segregated fund by a section 501(c)(3) organization results in loss of the organization's exempt status.

DISCUSSION

Basic Policy

Exempt organizations play a vitally important role in our society. The numerous religious, charitable, and educational institutions in our country contribute to and enrich virtually every aspect of American life. These organizations do far more than simply "lessen the burdens of government," one of the traditional policy rationales for tax exemption, for they provide an abundance of diverse services and new ideas that no government could provide.

Notwithstanding the importance of these institutions to our society, present law reflects a Congressional judgment that in the matters of political campaigns and substantial lobbying activities the subsidy of tax deductible contributions generally

should be denied. In the words of Judge Learned Hand, "controversies of that sort must be conducted without public subvention; the Treasury stands aside from them". Slee v. Commissioner, 42 F.2d 184 (2d Cir. 1930).

Lobbying Activities

The rationale for the current restrictions on lobbying activities has never been clearly articulated. The current restriction on lobbying activities by section 501(c)(3) organizations was added to the tax law in 1934 by a Senate floor amendment. The legislative history regarding the amendment is inconclusive as to the purpose and scope of the provision, but suggests that one of the reasons for enacting the provision was to deny a tax deduction for contributions made to serve the "selfish" and "personal" interests of the donor.

Although the general rule is that organizations eligible to receive tax deductible contributions may not engage in substantial lobbying, the overall statutory scheme is not entirely consistent. For example, veterans' organizations exempt under section 501(c)(19) of the Code are not subject to restrictions on lobbying, although they are entitled to receive tax deductible contributions. Moreover, under section 162(e), business deductions are disallowed entirely for grass roots lobbying, but are allowed without restriction for direct lobbying on matters of direct interest to the taxpayer. Section 501(c)(3) organizations, by contrast, are generally allowed to engage in both direct and grass roots lobbying to some extent. Private foundations, however, are not allowed to lobby at all without incurring a tax.

The basic rules regarding lobbying by tax exempt organizations have received significant consideration by Congress during the past 20 years. The rules with respect to private foundations were the subject of careful deliberation prior to the enactment of the current rules in 1969. In 1983, this Subcommittee reviewed the private foundation rules and did not recommend any changes in this area. With respect to public charities, lobbying activities were the subject of extensive discussion in Congressional hearings in the early 1970s. Some suggested that public charities should not be allowed to engage in grass roots lobbying at all but rather, like businesses, should be allowed to engage only in direct lobbying on matters directly related to their exempt purposes. Such a rule, it was argued, would create a more equitable balance between the tax treatment of exempt organizations and businesses engaging in lobbying. Others suggested that some restrictions should be imposed on the type of direct lobbying in which public charities could engage. In 1976, when Congress enacted the expenditure test and other provisions relating to lobbying by public charities, it struck a balance that permits section 501(c)(3) organizations to engage in both grass roots lobbying and direct

lobbying, but continues to restrict the extent of their lobbying activities.

Although a conceptual argument may exist for more parallel treatment of legislative activities of businesses and section 501(c)(3) organizations, Congress has not followed this approach in the past. Moreover, there would be a substantial revenue impact associated with a liberalization of the amount of direct lobbying permitted by section 501(c)(3) organizations, because organizations presently exempt under section 501(c)(4) could convert to section 501(c)(3) status, and thereby become eligible to receive tax deductible contributions. In light of these factors, and recognizing that present law represents a compromise among competing views, the Treasury Department does not recommend changes in the restrictions on lobbying by exempt organizations.

Political Activities

As with the restriction on lobbying activities, there is little legislative history regarding Congressional intent in enacting the prohibition against political campaign activities by section 501(c)(3) organizations. The prohibition was added by a Senate floor amendment to a bill which became the Internal Revenue Code of 1954.

The complete prohibition against political campaign activities by section 501(c)(3) organizations is sound tax policy. There is little to be said in favor of a general government subsidy of political campaigns by means of allowing tax deductible contributions to organizations participating in such campaigns. It would be difficult to describe most political campaigns as either charitable or educational endeavors, or even as a direct means of furthering one of the exempt purposes described in section 501(c)(3). Hence, the Treasury Department supports continuation of this prohibition.

While the Treasury Department does not recommend a change in the basic statutory scheme with respect to lobbying or political activities by tax exempt organizations, there are a number of specific issues that warrant Congressional attention.

Affiliated Exempt Organizations

As described above, a group that intends to engage in both educational and substantial lobbying activities may establish separate organizations. Typically, one organization is established under section 501(c)(3) to receive tax deductible contributions and to carry on educational activities, and a second organization is established as a social welfare organization under section 501(c)(4) to engage in lobbying activities. Such arrangements are clearly permissible under

current law as long as separate books are kept by the organizations. Nevertheless, such arrangements create difficult administrative problems for both taxpayers and the Service. The primary problem is the proper allocation of expenses between the two organizations.

Affiliated organizations often share facilities, staff, and equipment. Allocating such expenses to the proper organization is in some cases not an easy matter for either taxpayers or the government. The difficulties are exacerbated by a fundamental tension in the law. A section 501(c)(3) organization receives tax deductible contributions but its lobbying activities are limited to an insubstantial part of its total activities. In contrast, a section 501(c)(4) organization is not limited in its lobbying activities but is not entitled to receive tax deductible contributions. Thus, the law creates an incentive to allocate expenses to the section 501(c)(3) organization rather than to the section 501(c)(4) organization. For example, a section 501(c)(4) organization that is planning a lobbying campaign may have an affiliated section 501(c)(3) organization conduct research and prepare reports with a view to using such reports for lobbying. The organizations may allocate all of the research expenditures to the section 501(c)(3) organization and allocate only the cost of making direct contacts with legislators or members of the public to the section 501(c)(4) organization. A comparable situation exists when a section 501(c)(3) organization is affiliated with a section 527 political organization of a candidate for public office. Such section 501(c)(3) organizations may be used to research issues, prepare position papers, and sponsor "educational" forums at which the candidate is one of the principal speakers.

In order to enforce the requirement that affiliated organizations keep separate records and make reasonable allocations, the Service must be able to conduct a coordinated audit of the affiliated organizations. Under current law, this is difficult if not impossible. Despite their affiliation, the organizations in the examples described above file separate returns and in some circumstances may not disclose the extent to which the section 501(c)(3) organization has assisted the section 501(c)(4) or section 527 organization. Although Form 990, "Return of Organization Exempt from Income Tax," contains a question as to whether the organization is affiliated with any other organization, the question has failed to elicit useful responses for at least two reasons. First, there is no statutory definition (of general application) of affiliated exempt organizations. Second, there is no specific penalty for failure to disclose the names of affiliated organizations.

The ability of the Service to audit affiliated exempt organizations would be significantly improved by legislation. The Treasury Department suggests that the Subcommittee consider:

- (1) a statutory definition of affiliated exempt organizations;
- (2) a statutory requirement that organizations that meet the

statutory definition of affiliation disclose the names and taxpayer identification numbers of affiliated organizations; and, (3) appropriate penalties for failure to provide this information. The definition of affiliated organizations in section 4911, which applies to organizations electing to be covered by the expenditure test under section 501(h), could provide a starting point for such a definition.

While these suggestions would improve the ability of the Service to deal with abusive situations, other more subtle issues also arise from the use of related organizations. Under current law, for example, individuals are permitted artificially to divide interrelated activities that share a common objective among separate organizations. Even if separate books are kept and expenditures are reasonably allocated among the organizations, the activity of one organization complements, and thus benefits, the activities of the other organizations. For example, a candidate for political office (or an individual who is considering running for political office) receives indirect benefits when a related section 501(c)(3) organization conducts research and sponsors forums on issues that will be important to the candidate's campaign or when a section 501(c)(4) organization engages in lobbying activities on positions that the candidate has taken or expects to take in his campaign.

Since the tax law is structured to prohibit the use of tax deductible contributions and tax free investment income for private benefit or for political activity, such arrangements raise important issues of tax policy. Such arrangements may also raise important issues concerning the federal election laws. For example, the Federal Election Campaign Act ("FECA") imposes limits on the amount that persons may contribute annually to political organizations, requires disclosure of certain contributions, and prohibits corporations and labor unions, among others, from making contributions to political organizations. Some exempt organizations may be attempting to avoid the FECA rules through the use of section 501(c)(3) or 501(c)(4) organizations. Neither current law nor the suggestions above attempt to deal with these issues. Moreover, at this time the Treasury Department does not have specific data concerning the extent to which affiliated organizations are used to take advantage of the section 501(c)(3) status of one of the affiliates. The Treasury Department believes, however, that these issues raises important questions of public policy as well as tax policy and would be happy to work with the Subcommittee to study the matter further.

Sanctions

Lobbying Activities

As noted above, if a section 501(c)(3) organization does not

elect to be subject to the expenditure test, it is subject to loss of tax exempt status if it engages in substantial lobbying activities. Because of the vagueness of the "substantial part" test, the test provides little guidance to taxpayers and is difficult for the Service to administer. A vague standard is particularly troublesome in this situation because the only available sanction -- revocation of tax exempt status -- is sometimes unduly harsh. Moreover, the vagueness of the standard and the harshness of the sanction leave the Service open to accusations of politically motivated enforcement.

The elective expenditure test under section 501(h) represents a significant improvement over the substantial part test. Admittedly, an expenditure test is not necessarily the best measure of the extent of an organization's lobbying activities in all cases. In addition, even though the dollar amount of permissible lobbying is a precise standard, it must be applied to an activity that is difficult to define and that raises difficult allocation issues. However, while the expenditure test is not perfect from a theoretical standpoint and is not entirely precise, on balance it represents a reasonable and objective measure of lobbying activities.

The imposition of excise taxes on organizations that exceed the applicable limits under the expenditure test, with revocation of exempt status reserved as a sanction for those organizations that exceed the limits by a significant amount over a period of several years, is a considerable improvement over the substantial part test. The imposition of an excise tax is a more appropriate sanction for initial violations and provides fair warning, prior to revocation of exempt status, to organizations that are engaging in impermissible levels of lobbying activities.

Political Activities

As previously stated; under current law the only sanction for engaging in political activities is revocation of tax exempt status. Unlike the restriction on lobbying, the prohibition on participation in political activities is absolute and thus does not raise problems of measuring the level of the activity. Further, political activity is somewhat easier to define than lobbying activity. Even though the standards are more precise than with respect to the rules on lobbying, revocation of tax exempt status may still be unduly harsh in some instances. In other cases, such as where an organization has expended all its funds, it may have little or no impact on an organization.

The Treasury Department suggests that, in lieu of automatic revocation of exempt status, the Subcommittee consider the imposition of an excise tax on public charities that engage in political activities. Such a tax should be similar to the excise tax that is imposed on private foundations under section 4945. Thus, a tax should be imposed both on the organization and on the

management of the organization if it acted with knowledge that the expenditure was for political activities. Also, the statute should require correction of the prohibited expenditure either by recovery of the money or by such other means as the Commissioner may prescribe. Absent correction of the expenditure, or in cases of repeated or flagrant violations, the organization should be subject to loss of its exempt status.

Successor Organizations

Problems similar to those created by the use of affiliated exempt organizations also exist with successor organizations. Although section 504 of the Code, discussed above, prevents a section 501(c)(3) organization that has lost its exempt status because of substantial lobbying from becoming a section 501(c)(4) organization, it may be possible to circumvent the prohibitions against lobbying and political activities through the use of a series of section 501(c)(3) successor organizations.

For example, a group of individuals may establish a section 501(c)(3) organization, collect tax deductible contributions on behalf of the organization, and expend all of the organization's funds on lobbying or political activities. The group would then establish another organization, possibly with the same or a similar name, again collect contributions, and expend all of the second organization's funds, and so on. By the time the Service completes an audit of the first organization, it is a mere shell and the second organization has become the operative entity. This technique could be used indefinitely.

When an organization's exempt status is revoked, it is treated as a taxable organization until it can satisfy the Commissioner that proper precautions have been taken so that the organization will not again engage in substantial lobbying or political activities. A successor organization to one that has lost its exempt status because of excessive lobbying should be treated no more favorably. Present law, however, creates difficulties for the Service in tracing a series of successor organizations.

Although the Service could obtain information about predecessor organizations through a question on Form 1023, "Application for Recognition of Exempt Status Under Section 501(c)(3)," and could arguably treat a series of organizations as one, its ability to deal effectively with successor organizations would be enhanced by legislation. Accordingly, the Treasury suggests that the Subcommittee consider legislation that would: (1) require organizations applying for recognition of exempt status to disclose the names and taxpayer identification numbers of any "affiliated" organization (using the definition of general application discussed above) either currently in existence or in existence during a preceding period of, for example, five years,

and, (2) impose appropriate penalties for failure to provide such information.

Possible Sanctions Upon Revocation of Exempt Status

Notwithstanding the foregoing recommendations, the Treasury Department remains concerned that for some organizations loss of exempt status is an ineffective sanction. This is especially the case with short-lived organizations that realize a substantial tax benefit from the ability to receive deductible contributions but have very little to lose if the contributed money is expended for a prohibited purpose such as substantial lobbying activities. It would be impractical and unfair to seek to recover the tax benefit of these past deductions from the contributors to the organization. The Subcommittee might, however, wish to consider some form of additional sanction on organizations that lose their exempt status because of political or substantial lobbying activities. Such a sanction could include a monetary penalty on the organization or possibly a fine on the managers of the organization who knew of, or were responsible for, the impermissible conduct. Because of the vagueness of the "substantial part" test of section 501(c)(3), some form of preliminary, or warning, sanction could also be imposed in appropriate cases.

CONCLUSION

As described in greater detail above, the Treasury recommends consideration of the following changes to current law: (1) a statutory definition and required disclosure of affiliated exempt organizations on information returns with appropriate penalties for failure to provide such information; (2) an excise tax on section 501(c)(3) organizations that participate in political activities; and (3) required disclosure of current or past affiliated organizations on applications for recognition of exempt status. Further, consideration might be given to whether sanctions in addition to revocation of exempt status would be appropriate for organizations that lose their exempt status because of political activity or substantial lobbying. Treasury would be pleased to work with the Subcommittee and its staff to develop such proposals in greater detail.

This concludes my prepared testimony. I would be happy to answer any questions.

D. STATEMENT OF LAWRENCE GIBBS, COMMISSIONER,
INTERNAL REVENUE SERVICE

MARCH 12, 1987

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

GOOD MORNING. AS COMMISSIONER, I TRULY WELCOME THIS OPPORTUNITY TO REPORT ON THE SERVICE'S ADMINISTRATION OF THE TAX LAWS GOVERNING LOBBYING AND POLITICAL ACTIVITIES BY CHARITABLE AND OTHER TAX-EXEMPT ORGANIZATIONS. THE TAX LAWS IN THIS AREA AFFECT NUMEROUS KINDS OF ORGANIZATIONS, COVERING THE ENTIRE POLITICAL AND IDEOLOGICAL SPECTRUM, AND INVOLVE DIFFICULT ISSUES OF INTERPRETATION THAT SOMETIMES RAISE QUESTIONS OF CONSTITUTIONAL SIGNIFICANCE. AS A TAX ADMINISTRATOR, I AM PLEASED WITH THE CHAIRMAN'S STATEMENT IN ANNOUNCING THIS HEARING THAT HE WILL TAKE A "HARD LOOK" AT WHAT ORGANIZATIONS ARE DOING AND WHAT THE LAW ALLOWS.

ALTHOUGH I HAVE BEEN IN OFFICE AS COMMISSIONER FOR LESS THAN ONE YEAR, THE TAX ADMINISTRATION PROBLEMS OF LOBBYING AND POLITICAL ACTIVITIES BY TAX-EXEMPT ORGANIZATIONS ARE NOT ENTIRELY NEW TO ME. IN THE EARLY 1970'S WHEN I SERVED FIRST AS DEPUTY CHIEF COUNSEL AND THEN AS ASSISTANT COMMISSIONER (TECHNICAL), I HAD OCCASION TO ADDRESS SOME PROBLEMS IN THIS AREA. I HAVE FOUND THAT THEY DID NOT GO AWAY DURING THE LAST TEN YEARS THAT I WAS IN PRIVATE PRACTICE. WHAT I WOULD LIKE TO DO THIS MORNING IS TO DESCRIBE THE FOLLOWING FOR THE SUBCOMMITTEE:

- 1) THE CURRENT TAX ADMINISTRATION PROBLEMS IN THIS AREA, AND
- 2) THE EXAMINATION PROGRAM FOR TAX-EXEMPT ORGANIZATIONS.

I. CURRENT TAX ADMINISTRATION PROBLEMS

A. DEFINITIONAL ISSUES RELATED TO LOBBYING OR POLITICAL ACTIVITIES

IN EXAMINING INDIVIDUAL CASES, THE LOBBYING AND POLITICAL ACTIVITIES AREAS INVOLVE MANY AMBIGUITIES. FOR INSTANCE, SEVERAL STATUTORY TERMS ARE INHERENTLY DIFFICULT TO APPLY IN SPECIFIC FACTS AND CIRCUMSTANCES. APPLYING DEFINITIONS OF LOBBYING SUCH AS:

- "INTERVENING IN ANY POLITICAL CAMPAIGN ON BEHALF OF ANY CANDIDATE FOR PUBLIC OFFICE;"
- "CARRYING ON PROPAGANDA, OR OTHERWISE ATTEMPTING TO INFLUENCE LEGISLATION;"
- "ATTEMPTING TO INFLUENCE ANY LEGISLATION THROUGH AN ATTEMPT TO AFFECT THE OPINIONS OF THE GENERAL PUBLIC OR ANY SEGMENT THEREOF;" AND "MAKING AVAILABLE THE RESULTS OF NONPARTISAN ANALYSIS, STUDY, OR RESEARCH"

IS VERY DIFFICULT GIVEN THE NUMEROUS FACT SITUATIONS THAT CAN EXIST IN THE ACTIVITIES OF NON-PROFIT ORGANIZATIONS. NUANCES OF LANGUAGE IN THE ORGANIZATION'S PUBLICATIONS OR TIMING OF THE RELEASE OF A PUBLICATION CAN BECOME FACTORS.

ONCE THE DIFFICULT AND SENSITIVE DETERMINATION HAS BEEN MADE THAT AN ACTIVITY FALLS WITHIN THE SCOPE OF THE LOBBYING OR POLITICAL ACTIVITY RESTRICTIONS OF SECTION 501(C)(3), TWO OTHER MAJOR CONSIDERATIONS WILL OFTEN AWAIT

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THE EXAMINING AGENT. IN MANY CASES THERE MAY BE AN ATTRIBUTION PROBLEM, THAT IS, WHETHER THE ACT MAY BE ATTRIBUTED TO AN INDIVIDUAL RATHER THAN THE ORGANIZATION. NUMEROUS CHARITIES AND OTHER NON-PROFITS HAVE OFFICERS WHO MAY, ON OCCASION, CLAIM TO ACT ON THEIR OWN BEHALF RATHER THAN ON BEHALF OF THE ORGANIZATION IN ENDORSING A CANDIDATE OR ENGAGING IN A LOBBYING EFFORT.

SOME FACTORS THAT MAY BE CONSIDERED WOULD BE WHETHER ORGANIZATIONAL STATIONERY WAS UTILIZED; WHETHER AN ORGANIZATIONAL TITLE WAS USED; WHETHER THE EXECUTIVE STATED THAT THE ORGANIZATION WAS NOT INVOLVED AT THE TIME OF THE ACT; WHETHER THE BOARD OF DIRECTORS ENDORSED THE ACT; THE PUBLIC PERCEPTION OF THE ACT; WHETHER THE BOARD OF DIRECTORS DISAVOWED THE ACT; AND WHETHER THE EXECUTIVE NORMALLY ACTED FOR THE ORGANIZATION ON OTHER MATTERS.

EACH INDIVIDUAL CIRCUMSTANCE IS DIFFERENT, BUT ATTRIBUTION PROBLEMS OFTEN DO EXIST, PARTICULARLY WHEN THE CIRCUMSTANCES INVOLVE CLOSELY CONNECTED OR AFFILIATED SECTION 501(C)(3) CHARITABLE AND 501(C)(4) SOCIAL WELFARE ORGANIZATIONS AND POLITICAL ACTION COMMITTEES.

A SECOND MAJOR PROBLEM AFTER A DETERMINATION HAS BEEN MADE THAT LOBBYING OR POLITICAL ACTIVITY HAS OCCURRED, INVOLVES MEASUREMENT OF THE AMOUNT OF THE ACTIVITY. THIS FACTOR IS, OF COURSE, CRUCIAL IN DETERMINING WHETHER AN ORGANIZATION ENGAGED IN SUBSTANTIAL LOBBYING OR, IF THE ORGANIZATION MADE THE SECTION 501(H) ELECTION, WHETHER THE ORGANIZATION REMAINED WITHIN THE NON-TAXABLE EXPENDITURE LIMITS.

IN MEASURING LOBBYING UNDER THE "SUBSTANTIAL PART" TEST AND POLITICAL ACTIVITY, THERE ARE VARIOUS CONSIDERATIONS THAT MAY BE TAKEN INTO ACCOUNT. SOME ACTIVITIES ENGAGED IN BY ORGANIZATIONS MAY HAVE GREAT IMPACT ON THE OPINIONS OF THE GENERAL PUBLIC WITH LITTLE OR NO FINANCIAL INVESTMENT BY THE ORGANIZATION. UTILIZATION OF VOLUNTEERS ALSO MAY RESULT IN SIGNIFICANT IMPACT WITH ONLY VERY MINOR EXPENDITURES BY THE ORGANIZATION.

IN MEASURING QUANTITATIVELY, MANY FACTORS OF ALLOCATION ARE INVOLVED UNDER ANY GIVEN FACTS AND CIRCUMSTANCES OF AN ORGANIZATION. FOR INSTANCE, WHEN AN ACTIVITY INVOLVES BOTH LOBBYING AND EDUCATIONAL OR CHARITABLE PURPOSES, HOW SHOULD AN ALLOCATION BE MADE? NEEDLESS TO SAY, EVEN A REASONABLE ALLOCATION STANDARD IN THIS HIGHLY SENSITIVE AREA WILL NOT ALWAYS RESULT IN AN UNCHALLENGED DETERMINATION. CONSIDERATIONS OF RESEARCH COSTS AND OVERHEAD EXPENSES ARE ALSO INVOLVED. WHEN A PUBLIC CHARITY ELECTS UNDER SECTION 501(H), ADDITIONAL CONSIDERATION INVOLVES DISTINGUISHING BETWEEN DIRECT AND GRASSROOTS LOBBYING, A DISTINCTION WHICH IS NOT MADE UNDER THE "SUBSTANTIAL PART" TEST FOR LOBBYING BY NONELECTING ORGANIZATIONS. HOWEVER, ONLY A QUANTITATIVE ANALYSIS BASED ON EXPENDITURES IS USED WHEN A CHARITY ELECTS UNDER SECTION 501(H) -- A SIGNIFICANT ADVANTAGE OVER THE "SUBSTANTIAL PART" TEST.

ONCE AN EXAMINING AGENT HAS RESOLVED ATTRIBUTION AND ALLOCATION QUESTIONS, HE OR SHE IS THEN FACED WITH COMBINING THESE, BOTH QUALITATIVELY AND QUANTITATIVELY, TO DETERMINE WHETHER THE ORGANIZATION ENGAGED IN SUBSTANTIAL LOBBYING. IF POLITICAL INTERVENTION IS INVOLVED, THE PROHIBITION IS ABSOLUTE; HOWEVER, SOME CONSIDERATION MAY BE GIVEN TO WHETHER, QUALITATIVELY AND QUANTITATIVELY, THE ORGANIZATION IS IN THE CIRCUMSTANCE WHERE THE ACTIVITY IS

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SO TRIVIAL IT IS WITHOUT LEGAL SIGNIFICANCE AND, THEREFORE, DE MINIMIS. THE FEW COURT CASES DISCUSSING THE "SUBSTANTIAL PART" TEST FOR LOBBYING ACTIVITY HAVE GENERALLY CONCLUDED THAT THE FACTS AND CIRCUMSTANCES OF EACH CASE, RATHER THAN SET PERCENTAGES, ARE THE PROPER METHOD OF CONSIDERATION.

B. CHARITABLE AFFILIATES

MANY OF THE ALLOCATION AND ATTRIBUTION FACTORS ADDRESSED ABOVE ARE COMPOUNDED IN THE GROWING AREA OF CLOSELY CONNECTED SECTION 501(c)(3) AND 501(c)(4) ORGANIZATIONS AND POLITICAL ACTION COMMITTEES. MANY OF THESE CLOSELY CONNECTED ORGANIZATIONS OPERATE OUT OF THE SAME OFFICES, UTILIZE THE SAME EMPLOYEES, AND HAVE THE SAME BOARDS OF DIRECTORS. WHEN THE SAME EMPLOYEE WORKS FOR SEVERAL DIFFERENT ORGANIZATIONS THERE IS POTENTIAL FOR ABUSE IN ALLOCATING THOSE EXPENDITURES TO THE VARIOUS ORGANIZATIONS. TAX DEDUCTIBLE CONTRIBUTIONS TO THE SECTION 501(c)(3) ORGANIZATION PROVIDE A STRONG INCENTIVE FOR THE ORGANIZATIONS TO ALLOCATE AS MANY EXPENDITURES AS POSSIBLE TO THE SECTION 501(c)(3) ORGANIZATION. FOR INSTANCE, A SECTION 501(c)(3) ORGANIZATION COULD BE UTILIZED TO DEVELOP AND PERFECT A MAILING LIST THAT COULD BE USED BY A RELATED SECTION 501(c)(4) ORGANIZATION TO SOLICIT MORE ECONOMICALLY AND EFFICIENTLY POTENTIAL DONORS FOR LOBBYING OR POLITICAL PROJECTS.

ONE ESPECIALLY TROUBLESOME ENFORCEMENT PROBLEM OCCURS AFTER THE SERVICE CONCLUDES THAT A PARTICULAR SECTION 501(c)(3) ORGANIZATION ENGAGED IN LOBBYING BEYOND ALLOWED AMOUNTS AND THEN THAT ORGANIZATION SIMPLY GOES OUT OF EXISTENCE, WITH ANOTHER NEWLY CREATED SECTION 501(c)(3) ORGANIZATION TAKING OVER ITS FUNCTION. TYPICALLY, THE ORIGINAL SECTION 501(c)(3) ORGANIZATION WOULD SUFFER LITTLE IF ANY INCOME TAX CONSEQUENCE BECAUSE MOST OF ITS RECEIPTS WOULD NOT BE TAXABLE. ALSO, THE CONTRIBUTORS' TAX DEDUCTIONS FOR CONTRIBUTIONS MADE TO THE ORIGINAL ORGANIZATION IN PRIOR YEARS WILL NOT BE ADVERSELY AFFECTED. ABSENT FRAUD, THERE ARE NO FEDERAL TAXES OR PENALTIES ON THE ORGANIZATION'S MANAGERS.

C. INADEQUACIES OF SANCTIONS FOR VIOLATIONS OF THE SECTION 501(c)(3) PROHIBITIONS ON POLITICAL AND LOBBYING ACTIVITIES

AS NOTED ABOVE, THE SANCTION FOR VIOLATION OF THE PROHIBITIONS ON POLITICAL ACTIVITY AND LOBBYING ACTIVITY UNDER THE "SUBSTANTIAL PART" TEST IS LOSS OF EXEMPTION UNDER SECTION 501(c)(3).

WHEN THE TAX REFORM ACT OF 1969 WAS ENACTED, IT WAS ALREADY CLEAR THAT LOSS OF EXEMPTION WAS AN INAPPROPRIATE SANCTION AT LEAST AS IT APPLIED TO PRIVATE FOUNDATIONS. THE TAX REFORM ACT ADDED SECTION 4945 WHICH IMPOSED AN EXCISE TAX ON PRIVATE FOUNDATIONS' POLITICAL EXPENDITURES. IN AN ANALYSIS OF THE PRE-1969 SITUATION, THE JOINT COMMITTEE'S GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1969, AT PAGE 47, STATES:

ANOTHER PROBLEM AROSE FROM THE FACT THAT ABSOLUTE PROHIBITION UPON INVOLVEMENT IN POLITICAL CAMPAIGNS ON BEHALF OF ANY CANDIDATE FOR PUBLIC OFFICE FREQUENTLY RESULTED IN THE ALTERNATIVES OF UNREASONABLY SEVERE PUNISHMENT OR UNREASONABLY LIGHT PUNISHMENT. AS A PRACTICAL MATTER, MANY ORGANIZATIONS OFTEN FOUND WAYS OF MAKING CLEAR THEIR VIEWS REGARDING OPPOSING POLITICAL CANDIDATES WITHOUT FEAR THAT THEIR EXEMPT STATUS WOULD BE REVOKED....

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SECTION 4945 ATTEMPTED TO REMEDY THIS SITUATION FOR PRIVATE FOUNDATIONS BY IMPOSING AN EXCISE TAX ON POLITICAL EXPENDITURES.

WHERE A PUBLIC CHARITY VIOLATES THE SECTION 501(C)(3) PROHIBITION ON POLITICAL ACTIVITY, THE SANCTION IS AS INADEQUATE TODAY AS IT WAS FOR PRIVATE FOUNDATIONS PRIOR TO 1969. LOSS OF EXEMPTION IS UNREASONABLY SEVERE WHEN A PROHIBITED ACTIVITY IS NOT EXTENSIVE. FOR EXAMPLE, A PUBLIC CHARITY MIGHT CONTRIBUTE \$100 TO A POLITICAL CAMPAIGN AND, BECAUSE THE PROHIBITION ON POLITICAL ACTIVITIES IS ABSOLUTE, MIGHT JEOPARDIZE ITS EXEMPTION. IN MANY CASES LIKE THIS, AGENTS ARE RELUCTANT TO IMPOSE THIS SANCTION.

CONVERSELY, THE SANCTION MIGHT BE UNREASONABLY LIGHT IF A PUBLIC CHARITY HAS LITTLE OR NO TAXABLE INCOME. IN MANY OF THESE CASES, THE ONLY REAL CONSEQUENCE IS LOSS OF DEDUCTIBLE CONTRIBUTIONS. IF A PUBLIC CHARITY IS TREATED AS A TAXABLE ORGANIZATION AFTER REVOCATION OF EXEMPTION, LOSS OF EXEMPTION IS NOT PARTICULARLY PUNITIVE IN TERMS OF THE COST IN TAX DOLLARS. THERE IS NO TAX COST TO A PUBLIC CHARITY WHICH COULD QUALIFY UNDER SECTION 501(C)(4) DURING THE SAME PERIOD.

SECTION 501(C)(3) PROHIBITS ATTEMPTS TO INFLUENCE LEGISLATION IF THEY ARE A SUBSTANTIAL PART OF AN ORGANIZATION'S ACTIVITIES. IF AN ORGANIZATION DOES NOT ELECT SECTION 501(H) TREATMENT OR IF AN ORGANIZATION IS PRECLUDED FROM ELECTING THIS TREATMENT, THE ONLY SANCTION UNDER SECTION 501(C)(3) IS LOSS OF EXEMPTION. PRIVATE FOUNDATIONS, ALTHOUGH THEY ARE NOT ELIGIBLE FOR THE SECTION 501(H) ELECTION, ARE SUBJECT TO THE EXCISE TAX UNDER SECTION 4945 IF THEY ENGAGE IN ATTEMPTS TO INFLUENCE LEGISLATION.

LOSS OF EXEMPTION IS A CUMBERSOME SANCTION FOR ORGANIZATIONS ENGAGED IN ATTEMPTS TO INFLUENCE LEGISLATION FOR MANY OF THE SAME REASONS THAT IT IS CUMBERSOME FOR ORGANIZATIONS INVOLVED IN POLITICAL ACTIVITIES. IN ADDITION, HOWEVER, THERE IS THE DIFFICULTY OF MEASURING THE "SUBSTANTIALITY" OF THESE ACTIVITIES. LACK OF A PRECISE STANDARD CAUSES PROBLEMS FOR THE SERVICE IN ITS ATTEMPT TO ENFORCE THE STATUTE UNIFORMLY. IT ALSO HAS A NEGATIVE EFFECT ON CHARITABLE ORGANIZATIONS SINCE THEY CANNOT GAUGE THE PERMISSIBLE LEVEL OF THESE ACTIVITIES.

II. EXEMPT ORGANIZATIONS ENFORCEMENT PROGRAM

LET ME DESCRIBE TO THE COMMITTEE THE SERVICE'S EXAMINATION PROGRAM IN THIS AREA.

THE SERVICE SELECTS EXEMPT ORGANIZATION RETURNS FOR EXAMINATION FROM FOUR INDEPENDENT SOURCES.

MOST RETURNS ARE SELECTED BASED ON A COMPUTER SCORING SYSTEM SIMILAR IN APPROACH TO THAT USED FOR SCORING INCOME TAX RETURNS. THIS COMPUTER SCORING SYSTEM IS BASED ON INFORMATION FURNISHED ON THE ANNUAL RETURN AND IS INTENDED TO IDENTIFY THOSE RETURNS MOST IN NEED OF EXAMINATION.

A SECOND SELECTION CATEGORY IS THE TAXPAYER COMPLIANCE MEASUREMENT PROGRAM (TCMP) FOR EXEMPT ORGANIZATION RETURNS. THIS ALSO PARALLELS OUR INCOME TAX APPROACH, AND IS A SCIENTIFICALLY DESIGNED RANDOM SAMPLE OF RETURNS THAT ARE AUDITED IN DETAIL. THE RESULTS OF THE TCMP EXAMINATIONS FORM THE BASIS OF THE COMPUTER SCORING

MENTIONED ABOVE. THE TCMP PROGRAM IS DESIGNED TO ASSIST THE SERVICE IN IDENTIFYING THE OVERALL LEVEL OF COMPLIANCE BY TAX EXEMPT ORGANIZATIONS AND TO ASSIST THE SERVICE IN DETERMINING HOW TO ALLOCATE STAFF RESOURCES. THE MOST RECENT TCMP EXAMINATIONS IN THE EXEMPT ORGANIZATION AREA WERE CONDUCTED BETWEEN 1980 AND 1985, AND THEIR RESULTS WERE INCORPORATED IN COMPUTER SCORING PERFORMED AFTER JANUARY 1, 1986.

A THIRD SOURCE OF EXAMINATIONS IN THE EXEMPT ORGANIZATION AREA IS BASED ON INPUT FROM THE PUBLIC. AS IN THE INCOME TAX AREA, THE SERVICE RECEIVES INFORMATION FROM A MULTITUDE OF SOURCES, INCLUDING THE MEDIA, THE CONGRESS, AND THE GENERAL PUBLIC, SUGGESTING THAT A PARTICULAR ORGANIZATION MAY BE CARRYING ON NONEXEMPT ACTIVITY.

INFORMATION OF THIS SORT IS USED BY OUR DISTRICT OFFICES, WHICH EVALUATE THE INFORMATION AND DECIDE WHETHER AN EXAMINATION IS WARRANTED. THE DECENTRALIZATION OF RESPONSIBILITY FOR MAKING DECISIONS ON WHETHER TO CONDUCT AN EXAMINATION WITH RESPECT TO INFORMATION OF THIS SORT IS INTENTIONAL. IT IS DESIGNED TO MINIMIZE POLITICAL INFLUENCE, AND IS A POLICY OF LONGSTANDING DURATION THAT WAS FORMULATED WHEN THE SERVICE WAS REORGANIZED IN THE EARLY 1950'S.

THE FOURTH SOURCE OF EXAMINATIONS IN THE EXEMPT ORGANIZATION AREA IS SPECIAL EMPHASIS PROGRAMS. AT VARIOUS TIMES, SPECIAL EMPHASIS IS PLACED ON A PARTICULAR AREA WHERE THERE ARE INDICATIONS OF POSSIBLE NONCOMPLIANCE. FOR EXAMPLE, A GREATER CONCENTRATION OF RESOURCES HAS BEEN USED IN PAST YEARS TO EXAMINE PRIVATE FOUNDATIONS, PRIVATE SCHOOLS, GRASSROOTS LOBBYING ACTIVITY, AND (CURRENTLY) ADMINISTRATIVE EXPENSES OF PRIVATE FOUNDATIONS.

OUR EXPERIENCE IS THAT PRESS ACCOUNTS AND INQUIRIES FROM THE GENERAL PUBLIC AND THE CONGRESS PROVIDE, AT PRESENT, THE BEST SOURCES OF INFORMATION REGARDING POSSIBLE NONCOMPLIANCE IN THE POLITICAL AND LOBBYING ACTIVITIES AREA. IN ADDITION, WE ARE PRESENTLY CONSIDERING THE ADVISABILITY OF ESTABLISHING A SPECIAL EMPHASIS PROGRAM. AS THE HOLDING OF THIS HEARING ATTESTS, THERE IS CONSIDERABLE DEBATE AS TO THE EXTENT OF QUESTIONABLE POLITICAL AND LOBBYING ACTIVITY. AND WHILE I CAN ASSURE THIS COMMITTEE THAT THE SERVICE'S EXAMINATION PROGRAM IN THIS AREA IS AN ACTIVE ONE, IT APPEARS THAT A SPECIAL EMPHASIS PROGRAM OF THE SORT WE HAVE CONDUCTED IN THE PAST, COULD BE AN APPROPRIATE MEANS TO DETERMINE THE EXTENT OF THE PROBLEM IN THIS AREA.

WE BELIEVE THAT EXISTING IRS STAFFING IS ADEQUATE TO MONITOR AND ENFORCE THE PRESENT LAW RESTRICTIONS ON LOBBYING AND POLITICAL ACTIVITIES APPLICABLE TO TAX-EXEMPT ORGANIZATIONS. CURRENTLY, WE CONDUCT APPROXIMATELY 20,000 EXAMINATIONS ANNUALLY AND HAVE A STAFF OF APPROXIMATELY 300 EXAMINERS.

III. SUMMARY AND CONCLUSION

THE CONGRESSIONAL RESPONSES IN 1969 RELATING TO PRIVATE FOUNDATIONS AND IN 1976 TO PUBLIC CHARITY LOBBYING CLEARLY REFLECTED A RECOGNITION OF THE DIFFICULTIES IN INTERPRETING AND ENFORCING THE TAX LAWS RELATING TO LOBBYING AND POLITICAL ACTIVITY BY TAX-EXEMPT ORGANIZATIONS. OTHER GROUPS, SUCH AS THE FILER

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COMMISSION, MADE SIMILAR OBSERVATIONS. WHILE THE 1969 AND 1976 LAW CHANGES ARE INDEED SALUTARY, THE FUNDAMENTAL PROBLEMS REGARDING RESTRICTIONS ON LEGISLATIVE ACTIVITIES CONTINUE TO REMAIN FOR PUBLIC CHARITIES OUTSIDE OF THOSE ELECTING UNDER SECTION 501(H), AND THE FUNDAMENTAL PROBLEMS REGARDING RESTRICTIONS ON POLITICAL ACTIVITY FOR ALL PUBLIC CHARITIES ARE THE SAME AS THEY HAVE BEEN AT LEAST FOR THE LAST THIRTY-THREE YEARS. UNLIKE GOOD WINE, THE SUBSTANCE HAS NOT IMPROVED WITH AGE.

OVER THE YEARS, THE AREA OF LOBBYING AND POLITICAL ACTIVITY BY TAX-EXEMPT ORGANIZATIONS HAS BEEN A HIGHLY SENSITIVE ONE THAT IS A SEEDBED FOR TAXPAYER CONTROVERSY. UNDER CURRENT LAW THE POTENTIAL FOR TAX ABUSE EXISTS, AND THERE IS LITTLE RISK OF PENALTY ON THE ORGANIZATION, ITS MANAGERS, AND ITS CONTRIBUTORS FOR MANY TYPES OF VIOLATIONS.

THE SUBSTANCE AND MECHANICS OF THE 1976 TAX LAW CHANGES FOR LOBBYING BY PUBLIC CHARITIES ARE BASICALLY SOUND. HOWEVER, ITS ELECTIVE NATURE PERPETUATES OLD PROBLEMS, LEAVING THE SERVICE WITH TWO SETS OF RULES IN PLACE. THIS DICHOTOMY ADVERSELY AFFECTS OUR ABILITY TO ADMINISTER THE LAW EVEN-HANDEDLY. AT THE SAME TIME, TAX LAW CHANGES MADE IN 1969 AFFECTING PRIVATE FOUNDATIONS CONTINUE TO WORK WELL.

WITH YOUR ASSISTANCE AND THE FULL COOPERATION OF THE SERVICE AND TREASURY, I AM HOPEFUL THAT TOGETHER WE CAN IMPROVE UPON THE CLARITY OF SOME FUNDAMENTAL RULES IN THIS AREA THAT WILL THUS BENEFIT THE AFFECTED ORGANIZATIONS. AT THE SAME TIME, I HOPE WE CAN MAKE THE PROBLEMS OF ADMINISTRATION MORE MANAGEABLE FOR THE SERVICE IN THE FUTURE.

IV. EXHIBITS/CHARTS

- A. GENERAL SUMMARY OF RULES RELATING TO POLITICAL ACTIVITIES OF TAX EXEMPT ORGANIZATIONS UNDER THE INTERNAL REVENUE CODE
- B. GENERAL SUMMARY OF RULES RELATING TO LEGISLATIVE ACTIVITIES OF TAX EXEMPT ORGANIZATIONS UNDER THE INTERNAL REVENUE CODE

Exhibit A

[illegible]

Exhibit B

INTERNAL SERVICE OF RULES RELATIVE TO
LIQUIDABLE UTILITIES OF TAX-EXEMPT ORGANIZATIONS UNDER THE
INTERNAL REVENUE CODE

	Designations Described in IRC 501(c)(3) which do not elect under 501(h)	Designations Described in IRC 501(c)(3) which elect under 501(h)	Designations Described in IRC 501(c)(3) - Private Foundations	Designations Described in IRC 501(c)(3) - Political Warfare Organizations	Designations Described in IRC 501(c)(3) - Political Organizations	Political Organizations
Applicable Statutory & Reg. Citation	26 U.S.C. 501(c)(3) (P.L. 90-150)(c) (3)-(1)(C)(3)(i) *	26 U.S.C. 501(h) 26 U.S.C. 4911	26 U.S.C. 501(c)(3) 26 U.S.C. 4945(a)(1) 26 U.S.C. 1.501(c)(3)-(1)(C)(3)(i)	26 U.S.C. 501(c)(14) 26 U.S.C. 4945(a)(1) 26 U.S.C. 1.501(c)(14)-(1)(C)(3)(i)	26 U.S.C. 501(c)(15) 26 U.S.C. 501(c)(16) 26 U.S.C. 4945(a)(1) 26 U.S.C. 1.501(c)(15)-(1)(C)(3)(i)	26 U.S.C. 527 26 U.S.C. 527(b)(1), 527(c)(1), 527(d)(1), 527(e)(1), 527(f)(1), 527(g)(1), 527(h)(1), 527(i)(1), 527(j)(1), 527(k)(1), 527(l)(1), 527(m)(1), 527(n)(1), 527(o)(1), 527(p)(1), 527(q)(1), 527(r)(1), 527(s)(1), 527(t)(1), 527(u)(1), 527(v)(1), 527(w)(1), 527(x)(1), 527(y)(1), 527(z)(1)
General Restrictions on Activities Under Internal Revenue Code	For Subchapter F of the Internal Revenue Code, the activities of the organization may be carried on for the purpose of influencing legislation.	Same as 501(c)(3) organizations except organization has elected to have certain safe harbor rules apply. Certain amounts within such percentages as not endangering status. 501(h) election is not available to churches, operating foundations or private foundations.	An election tax is imposed on organizations where the organization seeks to influence legislation. Certain amounts within such percentages as not endangering status. 501(h) election is not available to churches, operating foundations or private foundations.	No limitation on the amount of such activity so long as the organization is attempting to influence legislation that is exempt purposes.	Same as 501(c)(14)	May be more limited activity as long as the organization is attempting to influence legislation for the purpose of performing political activities. Inter alia, supporting candidates for public office.
Deductibility of Dues/Contributions to Entity by Donors/Members	Yes--as charitable contribution (up to 30% AGI), as long as general restrictions above are met. 1.170A-1(b)(5)(i).	Same as 501(c)(3) non-electing.	In general as a charitable contribution up to 30% AGI.	Not eligible for charitable contribution treatment. Possible treatment as business expense. See discussion of 501(c)(15) and (c)(16).	Dues are business expense except that if organization has substantial political or grassroots lobbying activity, portion of dues is nondeductible. See 1.162-20(c)(3).	Generally no. Non-Tax Reform Act of 1986 tax credit for political or grassroots lobbying activity. See 1.162-20(c)(3).
Taxes/Sanctions Imposed on Entity	Revocation of status if organization is found to have carried on prohibited activity in more than insubstantial amount. Permanent bar on becoming a 501(c)(4) entity under 504.	Expenditures in excess of safe harbor amounts are subject to 25% excise tax. Revocation occurs if expenditures exceed 150% of limits on a "four year forward moving average." If revoked then permanent bar on becoming a 501(c)(4) entity under 504.	A first-tier tax of 10% is imposed on individual expenditures that are not covered by an exception. A second-tier tax of 100% is imposed if the taxable expenditure is not corrected. A tax may be imposed on management.	None	None	In general, a nondeductible entity except that income and income is subject to taxation. Income for "non-exempt" activities may be taxed.
Disclosure of Activity on Application for Status	Yes--See Form 1023, Part III, Q 11.	Yes--See Form 1023, Part III, Q 11. Form 5768 is used to elect or revoke under 501(h).	Yes--See Form 1023, Part III, Q 11.	None-Exempt in general activities on Form 1024.	Same as 501(c)(14).	There is no disclosure on Form 1024.
Continuing Requirements for Disclosure of Activities	Yes--See Form 990 Schedule A, Part III, Q 1.	Yes--1. Form 990 Schedule A, Part III, Q 1 and Part VI, 2. Form 4720 to report excess lobbying expenses, if any.	Yes--1. See Form 990 PP Part VII, Q 1, 2. Form 4720 as to excise tax.	None	Yes--Form 990, Q 83 with regard to grassroots lobbying.	Yes--Form 990, Q 83 with regard to grassroots lobbying.
Public Disclosure of Unrelated Contributions	No	No	Yes, if contribution exceeds \$500 or more. See Form 990 PP, Part I, Q 1.	No	No	Yes, but only if contribution exceeds \$500 or more. See Form 990 PP, Part I, Q 1.